Petition

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No. 81-____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

NEW ENGLAND POWER COMPANY

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION *et al.*

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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QUESTION PRESENTED

In rate proceedings before the Federal Energy Regulatory Commission ("FERC"), New England Power Company ("NEP") sought to recover over a five-year amortization period its investments in planned generating facilities which were cancelled during planning or construction and to earn a return during the amortization period by including the unamortized balance of its investments in its rate base. FERC permitted NEP to recover its investments, but denied any return during the amortization periods. The question presented is:

Whether the denial during amortization periods of any return on dollars prudently invested in cancelled generating facilities constitutes a taking of an electric utility's property without just compensation where investors have not been compensated for the risk that a return might be denied on the dollars so invested.

PARTIES TO THE PROCEEDING BELOW

The following parties and intervenors appeared before the court of appeals: New England Power Company; Federal Energy Regulatory Commission; NEPCO Municipal Rate Committee, *et al.;* Fitchburg Gas & Electric Company; Dennis J. Roberts, II, Attorney General of Rhode Island; the Rhode Island Consumers' Council; the Rhode Island Division of Public Utilities and Carriers; the Massachusetts Department of Public Utilities; and the New Hampshire Public Utilities Commission.

Petitioner, New England Power Company, is a wholly-owned subsidiary of New England Electric System, a registered holding company under the Public Utility Holding Company Act of 1935, 15 U.S.C. 79 *et seq.* (1976). Petitioner is a parent of Connecticut Yankee Atomic Power Company, Maine Yankee Atomic Power Company, Vermont Yankee Nuclear Power Corporation, and Yankee Atomic Electric Company, and an

affiliate of Granite State Electric Company, Massachusetts Electric Company, The Narragansett Electric Company, New England Electric Transmission Corporation, New England Energy Incorporated, and New England Power Service Company.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-____

NEW ENGLAND POWER COMPANY

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION *et al.*

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

New England Power Company petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. A, *infra*) is not yet reported. Opinion 49 of the Federal Energy Regulatory Commission (App. C, *infra*) and its Opinion 49-A denying rehearing (App. D, *infra*) in Docket Nos. ER76-304 *et al.* and its order (App. E, *infra*) in Docket Nos. ER80-66 *et al.* are not officially reported.

JURISDICTION

The judgment of the court of appeals was deemed entered on October 15, 1981, when the opinion of the court was docketed.

A timely petition for rehearing was denied on November 24, 1981 (App. B, *infra*). An order extending the time within which to file a petition for a writ of certiorari to and including March 14, 1982, was issued by the Chief Justice on January 11, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 313(b) of the Federal Power Act, 16 U.S.C. 825*l*(b).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Fifth Amendment to the United States Constitution states that "No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

The applicable provisions of Section 205 of the Federal Power Act, 16 U.S.C. 824d, are set out in Appendix G, *infra*.

STATEMENT OF THE CASE

This case involves a fundamental question concerning the regulation of public utilities. By the Federal Energy Regulatory Commission's unquestioning and uncritical reliance on the so-called "used and useful" concept as a method for determining the components of a public utility's rate base, investors have been denied fair compensation for the use of their capital in circumstances showing indisputably that the investment of that capital was made prudently and in good faith for the purpose of maintaining adequate utility service to the public.

New England Power Company is a public utility which generates and sells electricity at wholesale in interstate commerce. In 1975, it filed a new wholesale rate schedule (designated R-10) with the Federal Power Commission [1] pursuant to Section 205 of the Federal Power Act. In its R-10 filing, NEP

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[1] Now FERC and referred to as FERC hereafter.

proposed to recover over a five-year amortization period its $13 million investment in the cancelled Salem Harbor Unit No. 5. It also proposed to continue to earn a return on this investment by including the unamortized balance of its investment in its rate base. The R-10 rates were in effect, subject to refund upon completion of FERC's investigation, from March 1976 until February 1977.

The need for the Salem Harbor unit first became apparent in early 1970, when NEP's load forecasts indicated that its customers' requirements would exceed base-load generating capacity by 1977.[2] The decision was made in that year to opt for a new oil-fired unit, and by August 1973, following engineering and site-location studies, plans were finalized to construct such a unit at Salem Harbor for operation beginning in 1978. In October 1973, however, an oil embargo was imposed by the Organization of Petroleum Exporting Countries. There followed a series of drastic increases in the prices of crude oil and oil products, and grave concerns about the future availability of oil as a source of fuel for electric generation. Responding quickly to these developments, NEP, on February 19, 1974, suspended construction and engineering on Salem Harbor Unit No. 5. On November 18, 1975, NEP cancelled the Salem Harbor project (R.438)[3]. NEP's $13 million investment in the project represented expenditures for site location, procurement, engineering, licensing and initial construction (App. A, p. 7).

In its R-10 opinion, FERC found the Salem Harbor expenditures to have been prudent in every respect, and accordingly approved NEP's proposal to amortize the Salem Harbor investment as a cost item in its cost of service for ratemaking

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[2] Like all electric utilities, NEP has a continuing obligation to insure the availability of sufficient generating capacity to meet its customer's demands. See, *e.g.*, R.I. Gen. Laws § 39-1-1 (1977).

[3] References are to the record before FERC.

purposes over a period of five years (App. C, pp. 30, 34). FERC noted that investors had not in the past perceived any risks associated with investments in planned generating units. The return allowed NEP in prior rate cases did not therefore include any compensation for the risk of not recovering investments in cancelled projects (App. C, p. 35). Despite this finding, FERC declined to include the unamortized portion of the investment in the rate base upon which a return is earned (App. C, p. 33). The effect of this decision was to deny investors any compensation for the time value of their money over the amortization period.

FERC's analysis of the question of rate base inclusion was perfunctory. It simply adopted with approval the following statement from the Administrative Law Judge's initial decision (App. C, p. 32):

> "There is no precedent, or reasonable justification in the record of this proceeding, to require ratepayers to pay a return on an expenditure that has not resulted in productive plant that is used or useful in the public service."

In a subsequent wholesale rate filing designated W-2, NEP sought recovery of its $30 million investment in a nuclear project which was cancelled before construction began and again sought to include in rate base the unamortized balance of the investment during the write-off period. This rate base request was summarily rejected by FERC on the basis of its earlier R-10 decision (App. E, pp. 5-6).

On judicial review, the court of appeals affirmed FERC's exclusion from rate base in the R-10 and W-2 cases of the unamortized investments in the cancelled plants (App. A, pp. 7-13). In the court's view, the issue was "whether FERC's refusal to include project expenditures in the rate base, while allowing their recovery as costs over time, is a valid approach to allocating the risks of project cancellation" (App. A, p. 8). The court of appeals rejected NEP's claim that FERC's action was

unconstitutional under the Fifth Amendment. It found "no constitutional infirmity in the challenged action," noting that it had sanctioned the "used and useful" doctrine in previous cases, and citing the "end result" approach to judicial review of rate orders established by this Court in *Federal Power Commission* v. *Natural Gas Pipeline Company of America*, 315 U.S. 575 (1942), and *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) (App. A, p. 9).

REASONS FOR GRANTING THE WRIT

This case presents a fundamental question concerning the constitutional integrity of the ratemaking process. The decision below upholds an administrative determination denying investors, for a significant period of time, any return on capital prudently invested in planned electric generating facilities. Moreover, the record before the agency firmly established that the investors had not been compensated for the risk that such a return might be denied. The absence of either a return on capital or fair compensation for the risk of no return deprives investors of their property without compensation in violation of the Fifth Amendment.

The issue presented has a critical bearing on the ability of the financially-troubled electric utility industry to provide adequate electric service.[4] The industry must raise enormous amounts of

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[4] One distinguished authority on public utility regulation and former regulator has characterized the financial condition of electric utilities as "abysmal"; their deteriorated financial performance "represents . . . a profound failure — I am tempted even to characterize it as a crisis — of the institution of regulation itself." Alfred E. Kahn, "Utility Regulation Revisited," presented at the Annual Symposium of the New England Conference of Public Utilities Commissioners (June 15, 1981) at 1. Secretary of Energy James B. Edwards has similarly concluded that the electric utility industry is in a "financial morass" and has noted the serious consequences if utilities are unable to finance the construction of new plants. Speech before the United States National Committee of the World Energy Conference (Oct. 28, 1981).

capital to finance plants that take well over ten years to plan and construct. In today's turbulent economy, however, many projects prudently undertaken have been cancelled due to changing circumstances. The willingness of investors to commit funds to future projects depends to a large extent on their confidence that the regulatory commissions will fairly compensate the investors through the rates the utilities are permitted to charge their customers. A decision by this Court confirming the constitutional requirement of fair compensation will help restore investor confidence in the financial integrity of the privately-owned electric utility industry.

This case also provides an appropriate vehicle for clarifying the meaning of *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). For nearly 40 years, the "end result" test of *Hope* (*id.* at 602) has deterred courts from examining the methods used to determine utility rates as long as the "end result" of a rate order does not appear to be confiscatory. Yet *Hope* expressly recognizes that utility equity owners are entitled to returns on their investments sufficient to maintain the financial integrity of the utility and fairly compensate investors for the risks assumed (*id.* at 603, 605). Current ratemaking practice has not maintained the "financial integrity" of the utility industry. The time is now ripe for this Court to clarify the minimal constitutional standards agencies must meet to avoid confiscating investor property.

I. The Denial Of Any Return During The Amortization Of Investments In Cancelled Projects Constitutes A Taking Of Property Without Just Compensation

A. Planning new generating facilities — the emergence of the issue

All electric utilities have a continuing obligation to provide adequate reliable service to the public. To discharge this obligation, a utility must periodically review its generating capacity in relation to its projections of its customers' future requirements. Of necessity, this process is imprecise. Due to the time required

to bring a new generating unit on line, a utility must make expenditures to meet anticipated changes in customer demand long before the changes occur. Expenditures are made for planning, site selection, environmental and engineering studies, equipment and fuel procurement, and regulatory activities. Under FERC regulation, these costs, the actual costs of construction of the unit and an allowance for funds used during construction are capitalized.[5] The utility recovers its investment by means of the annual charge for depreciation once the plant goes into operation. This charge is designed to recover the original cost over time. In addition, the utility is afforded the opportunity to earn a fair rate of return on the depreciated original cost of its investment until that investment is fully recovered.[6]

Over the past decade, several factors have combined to make the imprecise planning process even more difficult. The costs of all forms of energy have risen substantially; although this increase has had the beneficial effect of encouraging conservation, it makes the prediction of future system requirements extremely difficult. The availability of fuel supplies for electric generation has become uncertain; delays have been encountered in obtaining the state and federal licenses needed to construct new facilities; pollution control measures have added cost and delay to the construction process; equipment and construction costs have risen; and interest rates have been so

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[5] The allowance for funds used during constructing ("AFUDC") is in lieu of a current return which would be provided, for example, if the unfinished construction were allowed in rate base. Part of NEP's losses from its Salem Harbor and nuclear projects consisted of AFUDC. Thus, NEP's investors were compensated for the time value of their money until the project was cancelled. Thereafter, they were denied all compensation for the time value of this money.

[6] Since, under FERC regulation, the return is calculated only on the original cost of facilities, the investor does not receive the benefit of any appreciation in the value of facilities built or purchased with his funds.

high and so unpredictable as to cast doubt on the prospects for financing some new projects.

The result of such an economic and regulatory environment has been that many proposed generating plants have been cancelled even though substantial sums had already been expended on them. Some regulatory commissions have recognized the need to compensate investors fully by permitting recovery of the investments over a reasonable period together with a return on the investment during the amortization period. [7] Other commissions, like FERC below, have allowed recovery of the investment but denied any return. [8] In one jurisdiction, a state statute was interpreted to bar any recovery whatsoever. [9] In short, the issue of the appropriate ratemaking treatment of abandoned plant investments is important and has been re-

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[7] See, *e.g.*, *In the Matter of Rochester Gas and Electric Corporation et al.*, Case 27794, New York PSC Opinion No. 82-1, issued January 12, 1982 (allowing amortization plus carrying charge for recovery of expenditures of four utilities on the Sterling nuclear plant); *Consolidated Edison Co.*, Case 27744, NY PSC Opinion No. 81-4, issued March 12, 1981 (rate base inclusion of unamortized investment in Indian Point plant); *Wisconsin Electric Power Co.*, No. 05-CE-3, Wisconsin Public Service Commission, Feb. 14, 1980, abstracted in 40 PUR 4th 630, 688 (1981) (rate base treatment of expenditures on Joint Haven Nuclear Project authorized in the event of abandonment); *Carolina Power & Light Co.*, No. E-2, Sub 391, North Carolina Public Utilities Commission, May 9, 1980 (rate base treatment of expenditures on South River Nuclear Project).

[8] See, *e.g.*, *Application of the Detroit Edison Company*, 14 PUR 4th 223, 230-231 (Mich. 1976); *Application of Virginia Electric and Power Co.*, 29 PUR 4th 65, 81 (Va. 1979); *Matter of Public Service Electric and Gas Co.*, Docket No. PUC 877-79 (N.J. July 2, 1980), abstracted in 37 PUR 4th 631.

[9] *Office of Consumers' Counsel* v. *Pub. Util. Comm.*, 670 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed for lack of a "properly presented" federal question sub nom. Cleveland Electric Illuminating Co.* v. *Consumers' Council*, No. 81-1002, 50 U.S.L.W. 3587 (1982). Apparently, the constitutional issue was not properly raised before the Ohio Supreme Court.

solved differently in different jurisdictions. This Court should clarify the constitutional standards governing abandoned plant decisions.

B. FERC's decisions deprive NEP's investors of just compensation

Utility investors are entitled to compensation for the use of their money in one of two ways: either (1) they must be given a return on their investments [10] or (2) they must be compensated for the risk that they may in fact be denied any return for a substantial period. *Washington Gas Light Company* v. *Baker*, 188 F.2d 11 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 52 (1951).

FERC's decisions provide neither form of compensation. By excluding the unamortized balance of the prudent investments [11] from rate base, NEP's investors were denied a return during the amortization period. And FERC recognized that the investors had not been compensated for assuming this risk (App. C, p. 35). Where the investor has not received compensation in some other form for the use of his money, denial of an opportunity to recover a return on that money constitutes a failure to provide just compensation for the use of his capital. [12] This denial

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[10] This Court has recognized that the time value of money constitutes an essential part of the just compensation required by the Fifth Amendment. *Webb's Fabulous Pharmacies, Inc.* v. *Beckwith*, 449 U.S. 155 (1980); *United States* v. *Thayer-West Point Hotel Co.*, 329 U.S. 585, 588 (1947).

[11] In its R-10 decision, FERC found that NEP's $13 million investment in the Salem Harbor project was prudent (App. C. p. 30). In the W-2 proceeding, FERC disposed of the rate base issue on summary judgment without reaching the question of the prudency of NEP's investment in the nuclear project (App. E, pp. 5-6). Thus, the prudency of the nuclear project investment must be assumed for the purposes of this case.

[12] *See Penn Central Transportation Co.* v. *New York City*, 438 U.S. 104, 121, 136 (1978), where this Court emphasized the necessity, in a taking context, of allowing Penn Central ". . . to obtain a 'reasonable return' on its investment." *Id.* at 136.

violates the Fifth Amendment and the Federal Power Act, since the statutory just and reasonable standard coincides with the constitutional minimum. *Permian Basin Area Rate Cases*, 390 U.S. 747, 769-80 (1968).

II. The Application Of *Hope* To Current Utility Regulation Should Be Reviewed

This Court's decision in *Hope Natural Gas Co., supra*, has been widely interpreted to excuse courts from any obligation to scrutinize ratemaking methods underlying rate orders. The Court in *Hope*, however, did in fact review the Federal Power Commission's ratemaking method in concluding that the end result was reasonable. The Court noted that the Commission had stressed the importance of maintaining the financial integrity of the gas company and permitting it to attract capital on favorable terms, 320 U.S. at 604-05. The approved rates were sufficient to (*id.* at 605)

> enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed . . . .

Moreover, the Court found that the Commission's approval of an annual depreciation expense based on original cost assured that "the utility is made whole and the integrity of its investment maintained. No more is required" (*id.* at 606).

FERC's decisions in this case do not assure NEP's investors that the integrity of their investments has been maintained. To the contrary, a critical element of their investment — the time value of money — has been ignored. During the investment period, investors will not only be uncompensated for the risk associated with their investment, they will suffer significant losses due to the impact of inflation. [13]

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[13] The record shows that FERC's failure to allow any return on the unamortized balance of the investments in the abandoned plants will effectively deprive investors of 22 percent of their investments (R. 600).

Our economy today is far different than it was when *Hope* was decided nearly forty years ago. Inflation is at unprecedented levels. Demands for capital by the private and public sectors are at all time highs. The denial of a return on capital in times of high inflation for even a short period deprives an investor of a significant portion of his investment. This deprivation is just as certain as outright confiscation of a portion of the investment itself in times of low inflation. The application of the *Hope* standards to utilities and investors in today's drastically altered economic conditions needs to be reviewed. This case provides an appropriate occasion.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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March 15, 1982

Appendix

Case No. ____

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OCTOBER TERM, 1981

NEW ENGLAND POWER COMPANY,

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

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APPENDIX A

OPINION OF THE U.S. COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

(Filed October 15, 1981)

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 80-1343

NEPCO MUNICIPAL RATE COMMITTEE AND THE ELECTRIC DEPARTMENTS AND PLANTS OF ASHBURNHAM, ET AL., PETITIONERS

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

NEW ENGLAND POWER COMPANY, DENNIS J. ROBERTS, II, ATTORNEY GENERAL OF RHODE ISLAND, INTERVENORS

No. 80-1363

NEW ENGLAND POWER COMPANY, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

DENNIS J. ROBERTS, II, ATTORNEY GENERAL OF RHODE ISLAND, ET AL.,

NEPCO MUNICIPAL RATE COMMITTEE, ET AL., INTERVENORS

Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

No. 80-1364

NEW ENGLAND POWER COMPANY, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

NEPCO MUNICIPAL RATE COMMITTEE, ET AL.,
MASSACHUSETTS DEPARTMENT OF PUBLIC UTILITIES, ET AL.,
FITCHBURG GAS AND ELECTRIC LIGHT CO., INTERVENORS

No. 80-1745

NEW ENGLAND POWER COMPANY, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

NEPCO MUNICIPAL RATE COMMITTEE, ET AL.,
INTERVENORS

No. 81-1283

NEW ENGLAND POWER COMPANY, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

DENNIS J. ROBERTS, II, ATTORNEY GENERAL OF
RHODE ISLAND, ET AL., INTERVENORS

Petitions for Review of Orders of the
Federal Energy Regulatory Commission

Argued June 22, 1981

Decided October 15, 1981

Thomas N. McHugh, Jr., with whom *Robert C. McDiarmid*, *Robert Harley Bear*, and *Gary J. Newell* were on the brief, for NEPCO Municipal Rate Committee, et al., petitioners in No. 80-1343 and intervenors in Nos. 80-1363, 80-1364 and 80-1745. *John Michael Adragna* also entered an appearance for NEPCO Municipal Rate Committee, et al.

Leonard W. Belter, with whom *William A. Kehoe, III* and *Cheryl Lynn Williams* were on the brief, for New England Power Company, petitioner in Nos. 80-1363, 80-1364 and 80-1745.

Edward Berlin entered an appearance for New England Power Company, petitioner in 81-1283.

F. Joseph Gentili was on the brief for Massachusetts Department of Public Utilities, et al., intervenors in Nos. 80-1343, 80-1363, 80-1364 and 81-1283.

Stephen R. Melton, Attorney, Federal Energy Regulatory Commission, with whom *Robert R. Nordhaus*, General Counsel, and *Jerome Nelson*, Solicitor, Federal Energy Regulatory Commission, were on the brief, for respondent. *Barbara J. Weller* and *Jerome A. Cameron, Jr.*, Attorneys, Federal Energy Regulatory Commission, also entered appearances for respondent.

Harry H. Voigt entered an appearance for Fitchburg Gas and Electric Light Company, intervenor in No. 80-1364.

Before: TAMM and WALD, *Circuit Judges*, and HOWARD T. MARKEY,* *Chief Judge* of the United States Court of Customs and Patent Appeals.

Opinion for the court filed by *Chief Judge* MARKEY.

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* Sitting by designation pursuant to 28 U.S.C. § 293(a).

MARKEY, *Chief Judge:* The proceedings consolidated here for review were initiated by three separate rate increase filings of New England Power Company (NEP), an investor owned electric utility, under section 205 of the Federal Power Act. In each instance, the Federal Energy Regulatory Commission (FERC) suspended the rate filing and ordered an investigation. NEPCO Municipal Customer Rate Committee (Committee) and numerous other intervenors participated in the extensive proceedings before FERC.[1] In two proceedings (R-8 and R-10), FERC approved portions of the rate increases requested. The third proceeding (W-2) has not reached hearing stage, but is final in certain respects discussed below.[2] We remand three and affirm the remainder of FERC's determinations.

The R-10 rate investigation is the major proceeding among those on review. The initial determination of an Administrative Law Judge (ALJ) was modified by FERC, in its Opinion 49.[3] That Opinion affirmed the ALJ's exclusion of NEP's expenditures on a cancelled Salem Harbor construction project from the rate base. FERC departed in Opinion 49 from the ALJ's deter-

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[1] The Committee is an organization representing a number of unaffiliated wholesale customers of NEP. Intervenor Fitchburg Gas & Electric Company is also a customer of NEP. Intervenors Rhode Island Division of Public Utilities and Carriers, the Attorney General of Rhode Island, the Rhode Island Consumers Council, the Massachusetts Department of Public Utilities, and the New Hampshire Public Utilities Commission are statutory agencies empowered to act on behalf of the public in matters affecting electric rates.

[2] A substantial cross-over and continuity of issues occur in R-8, R-10, and W-2, and appear in FERC's opinions issued in the course of those proceedings. On review, we consider the last pronouncement of FERC on each issue.

[3] Opinion No. 49, *New England Power Company*, Docket No. ER 76-304 *et al.*, 18 FPS 5-84 (FERC July 19, 1979) (hereinafter Opinion 49).

mination: reducing NEP's rate of return on common equity from 13.5% to 13.12%; modifying NEP's capital structure to deduct the Yankee investment from NEP's common equity; deducting the tax expense arising from an excess of book over guideline depreciation on the NEP/Narragansett facility; and reducing NEP's charge for subtransmission service.

The R-8 rate determination[4] was before this court in *New England Power Company* v. *FERC*, No. 77-1844 *et al.* (D.C. Cir. August 1, 1979) (unreported memorandum opinion), where the result was a remand for: (1) further review of FERC's decision to exclude from the rate base NEP's investment in four nuclear power companies (the Yankees); (2) for consideration of NEP's income tax normalization in light of this court's opinion in *Public Systems* v. *FERC*, 196 U.S. App. D.C. 66, 606 F.2d 973 (D.C. Cir. 1979); and (3) to consider the justness and reasonableness of the rates allowed in view of FERC's final determination on (1) and (2).

Because R-8 was subjected to judicial review, FERC's final determination was reached in R-8 after its determination in R-10 and included revision of some conclusions reached in R-10. On the remand of R-8,[5] FERC reaffirmed its exclusion of the Yankee investments from the rate base, and revised the rate base to provide NEP a 13.28% return on common equity. FERC stated that its previous rate of return calculation did take into account the effects of tax normalization, but indicated that tax normalization rulemaking was still pending. An overall 9.26% rate of return was found just and reasonable

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[4] Opinion 803, *New England Power Company*, Docket No. E-8641 *et al.*, 12 FPS 5-341 (FPC June 6, 1977).

[5] Opinion No. 49-A, *New England Power Company*, Docket No. E-8641, *et al.* and ER 76-305 *et al.*, 20 FPS 5-334 (FERC Mar. 26, 1980) (hereinafter Opinion 49-A), and the Notice of May 22, 1980 denying rehearing.

in light of market costs of common equity, returns on similar risk investments, and NEP's ability to attract capital.

In W-2, FERC made a final decision on only certain aspects of the rate change, and issued an order applying Opinion 49. In so doing, FERC excluded from the rate base NEP's investment in two other cancelled projects (Units 1 and 2); adjusted the depreciation treatment of certain facilities; and allocated investment tax credit funds to the cost of service.

NEP objects primarily to FERC's excluding from its rate base its unamortized expenditures on the cancelled Salem Harbor project and on NEP Units 1 and 2; to the amount of return assigned to investment tax credit funds; to the depreciation treatment of the Narragansett facility; and to FERC's refusal to make certain upward adjustments to NEP's test year cost of service.

The Committee claims that FERC gave too much to NEP for the cancelled project, and should have made further downward adjustments to the test year cost of service. In addition, the Committee argues for a lower working capital allowance and rate of return, disputing FERC's adjustment for the Yankee investments, and claiming consumers should benefit from a $30,000,000 debenture issued by NEP's parent, New England Electric System (NEES).

ISSUES [6]

(1) Did FERC properly exclude NEP's cancelled project expenditures from the rate base?

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[6] Decision in this complex case is not aided by the presence in the briefs of passing, conclusory objections and broad-brush defenses having no effect on the ultimate conclusions required. No useful purpose would be served by discussion of those objections and defenses. It may be useful to caution, however, that persuasion and the judicial process are advanced by the aimed accuracy of rifles.

(2) Was FERC's treatment of NEP's tax credit funds proper?

(3) Did FERC err in calculating NEP's interest deduction?

(4) Did FERC abuse its discretion in its treatment of test year estimates?

(5) Did FERC employ a permissible method in determining NEP's reasonable rate of return on common equity?

(6) Did FERC err in rejecting an adjustment to NEP's capital structure to reflect a debenture issued by NEES?

(7) Did FERC err in denying NEP's proposed allocation of a Narragansett tax expense?

(8) Was a NEP bond issue properly included in its capital structure?

(9) Was FERC's denial of consolidated tax benefits to consumers supported in the record?

(10) Did FERC err in interpreting a settlement agreement on subtransmission expenses?

(11) What is the appropriate disposition on the issue of NEP's tax normalization and its effect on justness and reasonableness of NEP's rates?

OPINION

(1) *Cancelled Project Expenditures*

In 1971, NEP decided to construct an 850 megawatt oil-fired electric generating facility, a project called Salem Harbor No. 5, in view of then current load forecasts of a need for additional generating capacity by 1977. Initial preparations, including site location, procurement, engineering, and licensing activity, were undertaken. In 1973, NEP's plans for the project received

a fatal blow when the Organization of Petroleum Exporting Countries imposed an oil embargo. Sky rocketing fuel costs and resultant energy conservation measures affected a major change in NEP's anticipated load growth. Those and other factors persuaded NEP to cancel the project in 1975. A similar scenario led to cancellation of plans to build two nuclear power projects called NEP Units 1 and 2.

FERC found NEP's expenditures for the Salem project to have been prudent in all respects and recoverable from ratepayers over a five-year amortization period. FERC denied NEP's request to include unamortized expenditures on the Salem and Units 1 and 2 projects in the rate base because those expenditures did not result in an operation of facilities "used and useful" in providing electric service.[7]

The question in this section is whether FERC's refusal to include project expenditures in the rate base, while allowing their recovery as costs over time, is a valid approach to allocating the risks of project cancellation. NEP contends that FERC's approach denies the opportunity to earn a return on prudent investments in the cancelled projects and thus deprives NEP of property without just compensation in violation of the Fifth Amendment.

NEP says capital prudently invested in a generating facility is taken for public use and therefore must be included in the rate base. That view had its genesis in a dissenting opinion of Mr. Justice Brandeis in *Pacific Gas & Electric Co.* v. *San Francisco*, 265 U.S. 403 (1924). This court has recognized, however, that "Justice Brandeis' formula for ascertaining rate base—the

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[7] In W-2, FERC made no specific determination that expenditures on Units 1 and 2 were prudent, but that was unnecessary because those projects were excluded for failure to result in operation of used or useful facilities.

amount of capital prudently invested—was not to become the prevailing rule." *Democratic Central Committee* v. *Washington Metropolitan Area Transit Commission*, 158 U.S. App. D.C. 7, 485 F.2d 786, 801 (1973), *cert. denied sub nom., D.C. Transit System, Inc.* v. *Democratic Central Committee*, 415 U.S. 935 (1974).

The general rule recognized by this court is that expenditure for an item may be included in a public utilitys' rate base only when the item is "used and useful" in providing service; that is, current rate payers should bear only legitimate costs of providing service to them. This court has further held that the Federal Power Commission (FPC, now FERC) "may adopt any method of valuation for rate base purposes so long as the end result of the rate order cannot be said to be unjust or unreasonable". *Washington Gas Light Co.* v. *Baker*, 88 U.S. App. D.C. 115, 188 F.2d 11 (1950), *cert. denied*, 340 U.S. 952 (1951). That view accorded with the guideline expressed by the Supreme Court:

> The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority to make the pragmatic adjustments which may be called for by particular circumstances.

FPC v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

Accordingly, we find no constitutional infirmity in the challenged action.

NEP also argues that FERC's decision to exclude cancelled project expenditures from the rate base: is internally inconsistent; lacks rational explanation for, and discussion of policy implications in, exclusion of the cancelled projects from the rate base; and arbitrarily and capriciously fails to follow relevant precedent.

NEP's claim of internal inconsistency rests on the view that FERC, having allowed recovery for cancelled project expenditures, must include expenditures for cancelled projects in the rate base. We disagree.

A balancing of policy objectives is not synonymous with inconsistency. Because it would be inequitable to place on the utility the entire loss of expenditures prudent when made, FERC allowed recovery thereof over time. At the same time, FERC is charged with a duty to protect the consumer against unreasonably high rates. Far from an inconsistency, FERC here struck a reasonable balance between the interests of investors and ratepayers. This court has recognized the value and propriety of such a practical approach:

> This path between competing policy objectives—as one of those " 'pragmatic adjustments which may be called for by particular circumstances,' " *Permian Basin Area Rate Cases, supra*, 390 U.S. at 777 (quoting *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942))—is clearly within the province of the Commission, which " 'must be free . . . to devise methods of regulation capable of equitably reconciling diverse and conflicting interests,' " *Mobile* [*sic*] *Oil Corp.* v. *FPC*, [417 U.S. 283, 331 (1974)] (quoting *Permian Basin Area Rate Cases, supra*, 390 U.S. at 767).

Ashland Exploration Inc. v. *FERC*, 203 U.S. App. D.C. 436, 631 F.2d 1018, 1023 (1980), *cert. denied, sub nom., Tema Oil Co.* v. *FERC* —— U.S. ——, 101 S.Ct. 1358 (1981).

NEP's assertions of a lack of rational explanation and policy discussion merely express its dissatisfaction with FERC's determination. The opinions of the ALJ and FERC make plain that the record evidence was reviewed and the involved equities were weighed. No more is required. *See United States ex rel. Chapman* v. *FPC*, 345 U.S. 153, 171 (1953).

Because FERC has on occasion appeared to stray from the "used and useful" standard, NEP contends that application of that standard here fails to follow precedent. Those allegedly aberrant occasions, however, are not comparable.

In Order No. 555, *Order Adopting in Part Construction Work in Progress Rulemaking and Terminating Proceeding*, 10 FPS 5-1133 (1976), FERC included expenditures for Construction Work In Progress (CWIP) in rate base, pointing to the limited circumstances envisaged in 18 C.F.R. § 2.16:[8]

> Thus we will allow the inclusion of CWIP in rate base where the construction is of facilities to be used for the conversion to the burning of other fossil fuels of plants which now burn oil or gas.

Because none of NEP's cancelled projects involved the conversion described in Order No. 555, application of the standard here does not conflict with FERC's determination in that Order. *See Public Service Commission of N.Y.* v. *FPC*, 151 U.S. App. D.C. 307, 467 F.2d 361 (1972).

Similarly, nothing in *Washington Gas Light Co.* v. *Baker, supra*, or *Democratic National Committee* v.

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[8] 18 C.F.R. 2.16(a) (iv) (2) provides:

> Inclusion of construction work in progress in rate base of electric utilities.
>
> *Fuel conversion facilities;* i.e., facilities which enable a plant which previously burned natural gas to convert to use of other fuels and facilities which enable oil-burning plants to convert to fuels other than natural gas. Such facilities would include those which alter internal plant workings, such as oil or coal burners, soot blowers, bottom ash removal systems, and concomitant air pollution control facilities, as well as facilities needed for receiving and storing the alternate fuel, which would not be necessary if the plant continued to burn gas, or oil, as originally designed.

Washington Metropolitan Area Transit Commission, supra, conflicts with FERC's decision in this case. Those cases involved property used and retired from service before investors had been fully compensated. Neither case involved the issue presented here—how expenditures should be allocated when a project is cancelled before any use of the facility begins.

Another exception to the used and useful doctrine was discussed but not applied in *Tennessee Gas Pipeline Co.* v. *FERC*, 196 U.S. App. D.C. 187, 606 F.2d 1094 (1979), *cert. denied*, 445 U.S. 920 (1980), *cert. denied*, 447 U.S. 922. In that case, this court recognized FERC's inclusion of expenditures for alternative gas supply projects in the rate base. The included expenditures were those for research and development of synthetic natural gas (SNG) production, as outlined in 18 C.F.R. 201(103) (1978).[9] In *Tennessee Gas*, however, as here, the petitioner's expenditures at issue were found outside the scope of recognized exceptions to the used and useful standard and thus ineligible for rate base treatment. In affirming FERC's rejection of petitioner's claims for rate base treatment this court noted:

> The Commission had established such an exception for research and development costs, but the Transco projects failed to qualify for special R & D treatment. These expenditures were prudent investments, argues Transco; however, for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but also must be "used and useful" in providing service. The Commission

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[9] 18 C.F.R. 201(103)(A) (1978) provides:

Experimental gas plant unclassified.

This account shall include the cost of gas plant which was constructed as a research, development, and demonstration project under the provisions of paragraph C, Account 107, Construction Work in Progress—Gas, and due to the nature of the plant it is desirous to operate it for a period of time in an experimental status.

> did not abuse its discretion when it applied a policy "that SNG expenditures which do not qualify as R & D can be recovered, if at all, only through the price paid for actual SNG production sold in interstate commerce. [Footnotes omitted.]

606 F.2d at 1123-1124.

We therefore find FERC's refusal to include the contested expenditures in rate base to be consistent with its previous decisions and with judicial precedent. NEP has set forth no compelling reason for departing from that approach in this case.

(2) *Investment Tax Credit Funds*

The investment tax credit operates to reduce federal income taxes in relation to the amount a utility invests in new plant and equipment. For those investments, the utility takes a credit known as an Accumulated Deferred Investment Tax Credit (ADITC). The credit is measured by a statutory percentage of the investment in new qualifying facilities during the tax year. The objective is to stimulate business investment in new plants and equipment and thereby increase employment, productivity, and general economic activity. As an incentive, the credit has been turned on and off, and its statutory percentage adjusted from time to time, as economic conditions change.

The precise issue presented in this section involves the mechanics of FERC's rate base/rate of return determination. As a general proposition, a regulated utility is allowed to recover from ratepayers all of its expenses, including income taxes, plus a reasonable return on capital invested in the enterprise and allocated to public use. More precisely, the "return" is set by FERC at the level which allows the utility to recover the cost of various types of capital which it has raised and dedicated to public use. The capital so dedicated is derived from three sources: (1) long term bonds; (2) preferred stock

equity; and (3) common stock equity. The "cost" of (1) and (2) is readily ascertained by reference, respectively, to the required interest on bonds and the required dividend on preferred shares. The "cost" of (3), common stock, is often subject to argument and debate.

FERC determines an "overall" rate of return to be applied to the company's rate base by taking the three elements of a company's overall capital structure, i.e., the amount of bonds, preferred equity and common equity capital outstanding, weighing each in accordance with its proportionate representation of total capital, and applying the appropriate cost rate to each element to produce an overall cost rate or overall rate of return.

FERC concluded here that tax credit funds should be treated as though they were obtained from bonds, preferred equity, and common equity in the same proportions as those items are present in NEP's overall capital structure. NEP contends that the tax credit funds should be treated as though derived solely from common equity funds, thereby generating the higher rate of return earned by contributions of common shareholders.

Section 46(f) of the Internal Revenue Code (Code)[10] reflects the principal that regulatory agencies should not defeat the credit's intended purpose by requiring a utility to "flow through" to ratepayers the savings resulting from the credit.[11] Specifically, Section 46(f)(2), the provision under which NEP has elected to be covered, disallows the credit in two circumstances:

> (A) Cost of service reduction.—If the taxpayer's cost of service for ratemaking purposes or in its reg-

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[10] 26 U.S.C. § 46(f)

[11] See H.R. Rep. No. 92-533, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. Code Cong. & Ad. News 1825 at 1839; S. Rep. No. 92-437, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. Code Cong. & Ad. News 1918 at 1943.

> ulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or
>
> (B) Rate base reduction.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Thus, Section 42(f)(2)(A) allows a limited (a "ratable" portion) reduction of the cost of service and consequent flow through of that portion to ratepayers.[12] Section 42(f)(2)(B) specifies that a utility will lose the credit if the rate base is reduced by any part of the credit. As discussed below, the controversy regarding the application of Section 46(f)(2) revolves around the interpretation of the "ratable" portion of the credit, and whether the flow through of that portion to ratepayers impermissibly reduces the rate base.

I.R.S. has issued regulations implementing Section 46(f)(2). I.R.S. Regulation § 1.46-6(b)(3)(ii) states:

> (ii) In determining whether, or to what extent, a credit has been used to reduce rate base, reference shall be made to any accounting treatment that affects rate base. In addition, in those cases in which the rate of return is based on the taxpayer's cost of

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[12] Consumers receive the benefits of a ratable portion of the credit when that portion is viewed as paying part of the cost of service, typically by reducing the income tax liability of the utility. Because consumers' payments include a return based on the rate base, if the credit were viewed solely as reducing the rate base, the benefits of the credit would again inure solely to consumers. For the benefits to inure solely to investors, the entire credit must be viewed as paying part of the cost of investment property, with no reduction in either the cost of service or the rate base. Because consumers then would pay the same cost of service and return on capital, investors would earn a higher effective rate of return.

> capital, reference shall be made to any accounting treatment that affects the permitted return on investment by treating the credit in any way other than as though it were capital supplied by common shareholders to which a "cost of capital" rate is assigned that is not less than the taxpayer's overall cost of capital rate (determined without regard to the credit). What is the overall cost of capital rate depends upon the practice of the regulatory body. Thus, for example, an overall cost of capital rate may be a rate determined on the basis of an average, or weighted average, of the costs of capital provided by common shareholders, preferred shareholders and creditors.

In the proceedings below, FERC determined that the foregoing regulation requires that tax credit funds be assigned the established overall rate of return. As above mentioned, NEP challenges that determination noting that the regulation requires treatment of a tax credit fund "as though it were capital supplied by common shareholders." NEP thus focuses on the first portion of the regulation, arguing that FERC's reliance on the last sentence of the regulation results in a reduction of the rate base by the amount of the credit involved and thus results in a violation of Section 46(f)(2).

The assignment of a rate of return level to tax credit funds was extensively analyzed in this court's recent opinion in *Public Service Company of New Mexico* v. *FERC*, (No. 80-1200) (D.C. Cir. June 2, 1981). There this court held that FERC's assignment of the overall rate of return to tax credit funds does not violate section 46(f)(2). Noting an inconsistency of that result with a statement in the legislative history of section 46(f), this court nonetheless concluded that it was consistent with the language and overall design of Section 46(f)(2) and IRS regulation § 1.46-6(b)(3)(ii). *New Mexico*, slip opinion at 14. Reexamination of the lan-

guage and legislative history of section 46(f) in light of the present facts discloses no reason to depart here from the holding in *New Mexico.*

In *Kansas-Nebraska Natural Gas Company,* Opinion No. 731, 5 FPS 5-600 (FPC 1975), FPC allowed a common equity return level on tax credit funds, applying the interpretation of section 46(f) here advanced by NEP. *Kansas-Nebraska,* however, was decided before IRS promulgated the investment tax credit regulation (§ 1.46-6(b)(3)(ii)) relied on here by FERC. Indeed, the *Kansas-Nebraska* opinion includes a statement that regulations then under consideration (i.e., 26 C.F.R. No. 1.46-6(b)(3)(ii)) would allow a rate of return on tax credit funds equal to the *overall* cost of capital as determined without regard to the credit. *Id.* at 7. Those regulations were adopted in 1979 by the IRS and included § 1.46-6(b)(3)(ii) quoted above.[13]

In *Carolina Power and Light Company,* Opinion No. 19, 15 FPS 5-619 (FERC 1978), FERC relied on the same proposed IRS regulation as "support[ing] the contention by staff and intervenors that ADITC should be reflected proportionately in CP&L's capital structure and that the return allowed on ADITC should be measured by the overall rate of return rather than the higher common equity rate of return." *Id.* at 5-625. Since that decision, FERC has summarily denied all requests similar to that made here by NEP.

The introduction appearing in the Federal Register in relation to the 1979 amendment of regulation § 1.46-6(b)(3)(ii) states:

> The Committee reports also state that the limitations of section 46(f) were intended to achieve two goals:

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[13] NEP does not contest the implementation of those regulations. For a discussion of the implementation procedure, *see New Mexico, supra,* at 14-17.

> a sharing of benefits between consumers and investors and a limitation on Federal revenue losses. Under certain circumstances, the common shareholder equity rule [granting ADITC the return on common equity] would deny consumers any of the benefits of a credit and could force ratemaking authorities to set rates higher than the rates that would have been established had no credit been available. Under such circumstances, Federal revenue losses would not be merely limited to the amount of the credit, but would be reduced to an amount less than the credit. Congress did not intend to force consumers to subsidize the cost of the investment tax credit.

44 Fed. Reg. 17666, 17667 (1979). That explanation of the amendment is entitled to great deference, *E.P.A.* v. *National Crushed Stone Asso.* 449 U.S. 64, 101 S.Ct. 295, 307 (1980), and is consistent with FERC's treatment of tax credit funds here. *New Mexico, supra* at 17. Accordingly, we conclude that application of the overall rate of return is an acceptable interpretation of "ratable portion" and a flow through of that portion does not impermissably reduce the rate base. Hence FERC's treatment of NEP's investment tax credit funds was proper.

(3) *Calculation of NEP's Interest Deduction*

In determining a utility's federal income tax expense (as an element of cost of service) for rate-making purposes, FERC must determine NEP's interest expense, a deductible item. To the extent that interest expense decreases, tax expense increases, and customer rates must be increased to pay the tax expense.

In its December 31, 1979 order in W-2, FERC determined that NEP's interest deduction should be determined without regard to the tax credit. NEP argues that because FERC has already decreased cost of service by a ratable portion of the tax credit funds, the inclusion of those funds in the calculation of the interest deduction

further reduces cost of service, producing in turn, says NEP, an overall return lower than the minimum mandated by the Code and IRS regulations.

The question in this section is whether FERC may properly treat tax credit funds in relation to interest deduction in the same way it treats tax credit funds in relation to rate of return determination. FERC assumes that the company would, absent the credit, have acquired financing by using a combination of debt and equity in the same proportion they bear in present capitalization (less tax credit funds). That assumption creates an "alternative utility" that might have evolved in the absence of tax credit funds. The capital structure so created is speculative but permissible, in view of the impossibility of determining exactly what financing, and consequent interest payment, the utility might have arranged absent the investment tax credit. As FERC noted:

> The only administratively feasible approach is to assume that nothing except the source of cash would have changed if the credits had not been available. The Commission has thus determined that, for ratemaking purposes, it will be assumed that in the absence of investment tax credits a utility would have financed the ADITC portion of its rate base with the same proportions of debt and equity, reflected in its capital structure by which it has financed the remainder of its rate base.[14]

NEP and FERC offer contrasting and complex economic scenarios and relate them and their alleged results to § 46(f)(2)(A). As this court indicated in *New Mexico, supra*, however, our role does not entail economic speculation:

> As a matter of economic theory, the competing theories advanced by FERC and PNM raise ques-

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[14] Order accepting for Filing and Suspending Proposed Rates, FERC, Dec. 31, 1979, at 8, n. 15.

> tions that are undoubtedly complex. The question before this court, however, is not. The function of this court is not to speculate on the manner in which a utility would finance investment in a world devoid of the investment tax credit. Since no issue of statutory interpretation is presented, the question before this court is simply whether the factual assumption relied on by the Commission in applying the statute is arbitrary, capricious, or an abuse of discretion. We hold that it is not.

Id at 18.

This court went on to discuss application of the arbitrary/capricious standard to the issue presented here:

> As discussed above, we believe that the Commission's assumption of capital acquisition in the absence of the credit is not arbitrary, capricious, or an abuse of discretion. As a result, we affirm the Commision's decision to exclude ADITC from capitalization. Assuming that the capital otherwise provided by the credit would be supplied by debt as well as equity, the exclusion of ADITC from capitalization does not significantly affect the debt ratio. Consumers bear the same cost of service, excluding the ratable reduction permitted by the statute, as they would pay in the absence of the credit. No violation of section 46(f)(2) exists.

Id. at 23.

Accordingly, we find no reversible error in FERC's approach to calculation of NEP's interest deduction.

(4) *Test Year Estimates and Adjustments*

The R-10 proceeding was based on test year ratemaking concepts, under which, as set forth at 18 C.F.R. § 35.13, a utility seeking to raise wholesale electric rates must file cost of service data for two periods. Period 1 must contain actual data for the most recent 12 months

available. Period II, the test year, must contain estimated cost of service data projected over 12 consecutive months beginning after the end of Period I but not later than three months after the proposed effective date of the rate filing. 18 C.F.R. § 35.13(d)(3)(ii). Here, Period I is the year 1975 and Period II is 1976.

Because rate proceedings are protracted, actual Period II data often becomes available before or during the administrative hearing. Use of actual data does not necessarily lead to more just and reasonable rates, however. Actual costs may reflect unique, non-recurring situations, and substitution of actual data for test year estimates may cause interminable delays and dilatoriness in the hope that history might undermine a utility's estimates. *Indiana Municipal Electric Association* v. *FERC*, 629 F.2d 480, 483 (7th Cir. 1980).

A utility must present a full explanation of the bases for test year cost estimates, establishing the validity and accuracy of each, 18 C.F.R. § 35.13(d)(4), (5) *American Public Power Association* v. *FPC*, 173 U.S. App. D.C. 36, 522 F.2d 142 (1975), and the utility bears the burden of showing reasonableness in the increase requested. 16 U.S.C. § 824d(e). Once substantiated, those estimates become the bases for ratemaking unless a challenger can prove the projections unreasonable when made or that subsequent events indicate their use would yield unreasonable results. *Indiana Municipal, supra* at 485. NEP and the Committee contest not that regulatory framework but its application by FERC. Hence the questions in this section concern FERC's acceptance of certain test year estimates and its adjustments of others.

NEP claims that its over-estimate of revenue from contract demand sales[15] and its under-estimate of its

[15] Contract demand sales are those in which customers specify in advance the amount of power they will purchase.

purchased power expense should be corrected to adjust the cost of service in its favor. NEP also challenges as inconsistent and excessive FERC's adjustment to its coal handling estimate.

NEP provided testimony before the ALJ on each challenged item. It described its estimate of contract demand revenue, in light of actual data, as inherently inaccurate because the number of customers and sales amounts could not be precisely estimated. That claim is simply insufficient to support an adjustment to the test year estimate. NEP made no showing that its estimate was unreasonable when made, aside from implying that the claimed shortfall demonstrates unreasonableness *per se*. But estimates are inherently subject to error. Hence an error in estimation cannot of itself demonstrate unreasonableness in the estimate, nor does it vitiate use of the estimate for testing the justness and reasonableness of the rates. Accordingly, the requested adjustment to contract demand sales was properly denied. *Indiana Municipal, supra.*

Concerning NEP's requested adjustment for its purchased power expense, NEP never established the level of increased expense with a required degree of accuracy. Its initial estimate was between $500,000-$600,000, followed by an estimate of $400,000-$800,000, and then by an estimate of about $850,000. NEP's failure to supply a reliable figure prevented FERC from making a reasonable determination. Having failed to meet its burden of demonstrating that its requested adjustment in its purchased power estimate was just and reasonable,[16] NEP cannot be granted that adjustment on appeal.

Similarly, NEP's protest of FERC's adjustment to its coal handling expense was rejected for failure to present persuasive or probative evidence. NEP's coal handling

[16] 16 U.S.C. § 824d(e).

estimate was based on its assumption that it would burn coal for six months in place of oil. Because NEP did not get approval from environmental authorities, it burned no coal. The ALJ considered it unreasonable to assume coal handling costs without assurance of permission to burn coal. The ALJ correctly concluded, and FERC agreed, that the likelihood that coal would be used was too speculative and uncertain to justify inclusion of its cost in NEP's estimated cost of service. We consider that conclusion reasonable on this record.

Nor is there the contradiction NEP alleges between FERC's adjustment of the coal handling estimate and its refusal to adjust the contract sales estimate. The former was found unreasonable when made while the latter was found reasonable when made.

There was no error in FERC's disposition of the coal handling issue.[17]

The Committee attacks FERC's treatment of NEP's steam maintenance expense, working capital allowance, and treatment of income from Braintree Electric System (Braintree) and Boston Electric Company (BECO).

The Committee contends that the ALJ's $4,344 million downward adjustment to NEP's coal handling and associated steam maintenance expense was insufficient in light of NEP's actual Period I expenses. In response to that suggestion, the ALJ reviewed NEP's actual steam maintenance expenses from 1973 through 1976, and an

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[17] NEP further contends that even if the coal burning expense urged is correctly disallowed, the reduction in cost of service was beyond a corresponding amount. NEP's argument was considered and rejected by the ALJ who arrived at a different amount. That determination was neither unjust nor unreasonable in its consequence. *Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968).

estimated 1977 steam maintenance expense.[18] The ALJ concluded that, in view of increasing cost trends, the Committee's suggested use of 1975 actual expense as a base for test year (1976) steam maintenance expenses would produce an unduly low result. Instead, the ALJ applied this formulation:

> It is concluded that the appropriate adjustment for this overstatement is the difference between the originally estimated test year [1976] cost of $16.614 million for steam maintenance and the more recent estimate used by the company for 1977, of $12.39 million for this expense, resulting in an overstatement of $4.224 million for steam maintenance costs. After adjustment for the scheduled Brayton Point overhaul of $2.13 million, the steam maintenance overstatement is determined to be $2.094 million. Upon adding the $2.25 million estimated coal handling cost, the total overstatement for coal handling and steam maintenance is determined to be $4.344 million.

The Committee strenuously objects to use of the $12.39 million 1977 estimate as a basis for determining the 1976 expense, though the Committee itself submitted the 1977 estimate, supra, n. 18. The reasonableness of the 1977 estimate, however, is indicated by its falling more than $4 million below the original $16.614 million 1976 estimate, and by its in-line relationship with NEP's actual steam maintenance expenses from 1973 to 1976.[19]

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[18] NEP's actual steam maintenance expense was $7,252,194 in 1973; $12,462,367 in 1974; $10,086,000 in 1975; and $11,286,278 for the 12 months ending July 31, 1976. The 1977 estimate for steam maintenance expense, submitted by the Committee for purposes of showing the 1976 forecast to be abnormal and unreliable, was $12,390,000.

[19] NEP also objects to the ALJ's formulation, asserting that its 1976 estimate was unusually high because of timing of various expenses. The objections of the Committee and NEP

Moreover, as the Supreme Court has recognized, FERC need follow no single method in arriving at just and reasonable utility rates. *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508 (1979), *accord, American Public Power Association* v. *FPC, supra.*

The record establishes that the ALJ gave careful consideration to the evidence in arriving at an appropriate steam maintenance adjustment. The ALJ's determination, adopted by FERC, is supported by substantial evidence, 16 U.S.C. § 825(l)(b), and has not been shown to result in unjust and unreasonable rates, 16 U.S.C. § 824d(a). Accordingly, FERC's steam maintenance adjustment is upheld.

The Committee's argument concerning NEP's working capital allowance is similarly flawed. The Committee loses sight of its burden, arguing the weight of the evidence, by attacking the accuracy of testimony and associated FERC-adopted findings of the ALJ, rather than showing a lack of evidence to support those findings.

FERC adjusted NEP's cash working capital downward to reflect a fuel purchase arrangement between NEP and a subsidiary of Prudential Insurance Company. Under that arrangement (Pru-lease), the subsidiary purchases portions of NEP's fuel inventory, selling it back to NEP as it is burned. Because a reduction resulted in the working capital needed for fuel expense, NEP's requested 45 day capital allowance was reduced to a 20 day allowance. The ALJ found, and FERC agreed, that "it would be clearly unreasonable to authorize a 45 day working capital for fuel when NEP is required to supply funds to finance this cost for a period of only 20 days". The adjustment was supported by a

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must fail, for neither establishes that the estimates objected to were unreasonable when made or result in rates unjust and unreasonable.

NEP study disclosing a 20 day lag between NEP's payment for fuel and its receipt of revenue from its customers. That study constitutes substantial evidence supporting FERC's decision. 16 U.S.C. § 825(l)(B). The Committee having failed to show that decision unreasonable, it will not be upset merely because another was possible. *See Consolo* v. *Federal Maritime Commission*, 383 U.S. 607 (1966).

The Committee further says FERC acted inconsistently with its long-standing practice and policy[20] of "synchronizing" related items affecting cost. Having used actual data for determining the cash working capital allowance, FERC must, says the Committee, use NEP's actual income from the Pru-lease arrangement, must apply the actual prime rate to any claimed NEP expense in the Pru-lease arrangement, and must count the actual income from sale of surplus power to Braintree and the actual rental income from BECO, in determining the cost of service.

The ALJ rejected the Committee's proposal to relate the capital allowance under the Pru-lease arrangement, a rate base issue, to the cost of service. He determined that NEP's prime rate estimate was reasonable when made and rejected the Committee's requested adjustment to reflect the Period II actual prime rate as unsupported by evidence. The ALJ also concluded that there was no basis on which to have anticipated sale of surplus power to Braintree and rejected the Committee's proposed adjustment as an attempt to substitute actual data for estimated data. Because NEP's estimate included no rental income from BECO, the ALJ entered an amount, rejecting the actual amount sought by the Committee as

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[20] The Committee cites *Union Electric Co.*, 47 FPC 144, 150, *reh. denied*, 47 FPC 943 (1972) and *Pennsylvania Electric Co.*, Opinion No. 739-4, 10 FPS 50732 issued October 5, 1976, at pp. 3-4.

not reasonably foreseeable at the time the estimates were developed. *See Indiana Municipal, supra* at 483. FERC adopted the findings and conclusions of the ALJ on these items.

FERC cannot arbitrarily or discriminatorily change its policy.[21] We do not, however, view the 20 day capital allowance entered here by FERC and its treatment of the prime rate, Braintree and BECO matters, to have reflected an arbitrary or discriminatory change of policy. The capital allowance determination was supported by evidence. The challenge to the determinations on the prime rate and Braintree matters lacks a showing that those estimates were *substantially* in error because of subsequent events not reasonably foreseeable when the estimates were made. *Indiana Municipal, supra,* at 486. Substantiality is required to permit a degree of latitude "because overstated estimates would almost certainly be balanced by offsetting understatements." *Id.* Rectifying, in the light of actual data, a complete omission of a clearly identifiable income source (the BECO rental income) does not require that FERC adjust numerous other estimates reasonable when made.

NEP and Committee having failed to carry the challengers' burden, FERC's determinations respecting test year estimates and adjustments are affirmed.

(5) *Rate of Return on Common Equity*

The rate of return computations for NEP are complicated because NEES owns all the stock in NEP, and because NEP partially owns the Yankees. As a wholly owned subsidiary of NEES, NEP's cost of capital cannot be directly measured. Under these circumstances,

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[21] *Otter Tail Power* v. *FERC,* 583 F.2d 399, 408 (8th Cir. 1978), *cert. denied,* 440 U.S. 950; *see Greater Boston Television Corp.* v. *F.C.C.,* 143 U.S. App. D.C. 383, 444 F.2d 841 (1970), *cert. denied,* 403 U.S. 923 (1971).

FERC elected to use NEES' cost of equity capital as a substitute for NEP's in R-10. In Opinion 49-A, resulting from remand of R-8, supra, note 5, FERC determined that NEP was entitled to a 13.28% return on common equity, and affirmed its exclusion of NEP's Yankee investment from the rate base. The questions presented in this section are whether FERC's method of determining NEP's rate of return on equity in this case was permissible, and whether the resultant rate was supported by evidence.

A. *Exclusion of Yankee Investment From Rate Base*

In response to NEP's insistence that its investment in the Yankees be included in the rate base, FERC explained that the return on that investment is separately determined in proceedings relating to the Yankees. The Commission stated:

> After reconsideration, we still find the answer to the first question is that the NEP Yankee investment should be excluded from NEP's capital structure. This is so because the NEP Yankee investment is already reflected as common equity in the capital structures of the Yankee plants. Thus, it would clearly be inequitable for NEP, through the Yankee companies, to earn a return on that NEP investment in the Yankee rate proceedings and then for NEP to earn a return on that same investment in the NEP proceedings.[4] In other words, unless the Yankee investment is excluded from NEP's capital structure, the same investment would be taken into account again for ratemaking purposes. To avoid this dual impact, the Commission has consistently excluded the Yankee investments from the capital structures of the sponsoring companies.

[4] The rates charged NEP by the Yankee companies is reflected in NEP's cost of service as purchased power expense and thus passed through to NEP's customers.[22]

[22] Opinion 49-A, *supra*, n. 5, at 3.

As above indicated, FERC's initial determination to exclude NEP's Yankee investment entirely from common equity was remanded by this court. *New England Power Co.* v. *FERC*, *supra*. In its slip opinion at 5, this court noted a "meagre, if indeed not non-existent evidentiary foundation" for FERC's determination, noting further that NEP bears the burden of proving the constituent elements of its capital structure.

In Opinion 49-A, FERC reviewed the policy considerations supporting its determination to exclude Yankee investments and its consequences, that is, NEP will recover the cost of capital invested in its own facilities via the rate base, and will recover the cost of capital invested in the Yankees via its share of those companies' profits. FERC also noted that NEP had failed to make a persuasive showing in support of its burden of proof on including the Yankee investments. FERC thus articulated a rational basis for its determination, and NEP has not demonstrated that its capital structure necessitates the judicial substitution of a determination contrary to that of FERC.

As above indicated, resolution of conflicting economic issues is precisely within the expertise of FERC. It determined that NEP's rate of return on equity should be based on cost of capital invested in its own facilities commensurate with the attendant risks, noting that the risk and allowed rate of return differ on NEP's different investments.[23] That determination, which forms the basis

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[23] FERC pointed out that the most recent determination of an appropriate rate of return for a Yankee company resulted in the approval of a settlement agreement calling for a 10% return. The Committee was a party to that settlement. *See Yankee Atomic Electric Company and Public Service Company of New Hampshire*, Docket Nos. E-9420 and E-9421, Order Approving Settlement Agreement and Reversing Initial Decision On Rate of Depreciation, issued July 20, 1977.

for the exclusion of the Yankee investment, is neither devoid of reason nor lacking support in the record. *City of Cleveland* v. *FPC*, 174 U.S. App. D.C. 1, 525 F.2d 845 (1976). Accordingly, we affirm FERC's exclusion of the Yankee investment from common equity.

B. *Inclusion of Yankee Investment in Total Capital Structure.*

Using a capital market-oriented approach (the Discounted Cash Flow or DCF method) in R-10, FERC determined the rate of return which investors required before investing their money in the NEES enterprise, in light of available alternative investment opportunities, to be 12.75%. FERC also found that rate an appropriate proxy for the NEP composite rate,[24] noting that the testimony on derivation of NEP's rate of return value was primarily premised on the capital structure of NEP composite rather than on that of NEP operating alone.[25] FERC explained:

> In this case, NEP witnesses argued against excluding NEP-Yankee investments from total (composite) NEP capital structure. The implication of this observation is that when they used NEES-based information to estimate a rate of return value, it was a value intended to be applied to *both* the capital invested in NEP's own rate base and the capital invested in the Yankees. Consequently, although the witnesses did not explicitly state this, such a rate of return value probably is intended to reflect NEP-composite rather than just the NEP operating com-

[24] "NEP composite" refers to NEP as owner of NEP's operating rate base facilities and as owner of a share of the Yankee generating facilities. "NEP operating" refers to NEP only as owner of its own operating rate base facilities.

[25] Commissioner Holden felt that testimony on NEP's rate of return was based on NEP-operating information. We disagree.

ponent. We note, for example, that NEP Witness Benderly's direct testimony listed common equity at $288,984,425 which is (rounded) the $289 million figure we used for NEP-composite investment in Opinion No. 49. [Emphasis in original.]

FERC's method took account of the integration of Yankee data into NEP's overall capital structure and investment risk. Recognizing that NEP would earn approximately 10% on its Yankee investments, *supra*, note 23, FERC determined that NEP must be afforded the opportunity to earn a 13.28% return on its investment in its own operating rate base facilities, if it were to have the opportunity to earn 12.75% on a composite basis. FERC stated:

> The Commission's approach, which falls somewhere between that of NEP and the customers, is really quite straightforward: we find that NEES more closely resembles NEP-composite than it does NEP-operating. The investment in and earnings from the Yankee investment is a component of NEES and a component of NEP-composite; it is not a component of NEP-operating. Thus, we conclude that the rate of return we have determined appropriate for NEES is also appropriate for NEP-composite. The rest of the analysis is simply arithmetical: if NEP-composite is to have an opportunity to earn 12.75%, and the portion of NEP-composite reinvested in the Yankees is earning approximately 10%, then the return from NEP-operating must be in excess of 12.75%. This approach does not, as customers contend, result in an equalization of return on investment for NEP-operating and NEP-Yankees. Neither does it flow from a perception that the respective risks are equal. To the contrary, implicit in the approach is a recognition that the risk and appropriate returns are different. Furthermore, by this process, the Commission has not improperly guaranteed earnings to shareholders, as the customers have argued. Instead, the rate of return

> determination represents no more than a measure of NEP-operating's cost of capital, given what we know about NEES shareholders' risks and required returns. [Footnote omitted.]

The Committee and intervenors argue that FERC is allowing NEP, as a shareholder, to collect rates for Yankee companies' power which exceed those companies' FERC-approved rate schedules. Although FERC's method does not change the rate which Yankee companies collect from their customers, the Committee says the method effectively allows FERC to structure rates whereby NEP is able to earn a return on its Yankee investments greater than that envisaged in the Yankees' filed rate schedule and thus violates the "filed rate" doctrine.

The Supreme Court, in originating the filed rate doctrine, stated that "[a utility] can claim no rate as a legal right other than the filed rate, whether fixed or merely accepted by the Commission . . . ." *Montana-Dakota Utilities Co.* v. *Northwestern Public Service Co.*, 341 U.S. 246, 251 (1951). "The considerations underlying the [filed rate] doctrine . . . are preservation of the agency's primary jurisdiction over reasonableness of rates and the need to insure that regulated companies charge only those rates of which the agency has been made cognizant." *City of Piqua* v. *FERC*, 198 U.S. App. D.C. 8, 610 F.2d 950, 955 (1979) quoting *City of Cleveland* v. *FPC*, *supra*, 525 F.2d at 854.

FERC's predecessor agency recognized that differences in rates allowed individual utilities and associated returns are justified when predicated on differences in facts or management conditions. *St. Michaels Utilities Commission* v. *FPC*, 377 F.2d 912 (4th Cir. 1967). Although *St. Michaels Utilities Commission* deals with rate classes of one utility, not with a relationship between rates of two separate utilities, its underlying ra-

tionale is applicable here. The difference in return levels of NEP's Yankee investment and its investment in its own generating facilities is attributable to residence of those investments in two distinct sets of separate utilities, namely NEP-operating and the Yankee companies. Differences in rates and returns associated with those two sets of investments result from independent ratemaking processes, where the circumstances of each specific utility are considered. The return authorizable for NEP is therefore not necessarily limited to that authorized the Yankee facilities or to that authorized any other regulated industry in which NEP may have an interest.[26]

Moreover, FERC methodology is more accurately characterized as separating, rather than as creating an upward adjustment of return on, NEP's Yankee investment. Hence FERC's method does not violate the filed rate doctrine. Nor do we consider the difference between the 12.75% rate of return and the 13.28% NEP-operating rate of return to have resulted from an "adjustment" in the latter to take further account (beyond that resulting from DCF analysis) of a shift in risk; rather, the difference comes about through a separation of the components of NEP-composite, and a calculation of a weighted average of the respective components' rates of return to deduce the implied 13.28% rate of NEP-operating.

The Committee claims that the return on equity rate is not just and reasonable when considered under the "end result" test of *Permian Basin*, *supra*, and other

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[26] Commissioner Holden suggests that NEP investors should be limited to a 10% return on that portion of their capital invested in the Yankees. That approach risks relinquishment of FERC's control over the portion of a utility's capital invested in another utility. FERC may find Commissioner Holden's suggestion appropriate in some other proceeding. We find no error, however, in the methodology adopted by the FERC majority in R-10.

authorities. To upset FERC's determination, however, the Committee bears a heavy burden. *FPC* v. *Hope Natural Gas*, 320 U.S. 591 (1944) at 602. Ratemaking is a complicated process involving many factors, e.g., money market conditions, financial health of the utility, and financial risks. As the ALJ noted,

> Mathematical computations used to support desired results relating to rates of return have the ring of authority, but simplistic formula approaches cannot be relied upon as sole determinants of a reasonable level of earnings for a regulated utility. Prudent judgment, consideration of the earnings of comparable companies and the requirements of the traditional *Bluefield* and *Hope* doctrines must be the basis for the determination of fair levels of earnings for regulated utilities. [Footnote omitted.]
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> * * * *
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> The approaches used by witnesses for both NEP and other parties in deriving their recommendations for an equitable return for NEP are predicated upon the same basic data relating to earnings of comparable companies, historic earnings patterns of NEES, market prices of NEES securities, and related factors. In addition, these witnesses have made liberal use of various judgmental and subjective factors, including arbitrary adjustments relating to the estimated cost of equity, differences between cost of equity and bond yields, stock prices and other measures.

As we have noted, in arriving at just and reasonable rates, FERC is not bound "to the service of any single formula or combination of formulas". *FPC* v. *Natural Gas Pipeline Co., supra*, 315 U.S. at 586. The ALJ found a 13.5% return on equity reasonable. FERC reduced that rate to 13.28%. Further, the testimony and evidence indicating a required rate of return on equity ranging from 11.21% to 13.3% supports FERC determination of a 13.28% return. That determination, sup-

ported by substantial evidence, falls within the zone of protection from the authority of courts to set it aside. *FERC* v. *Penzoil Producing Co.*, *supra*, 439 U.S. at 517; *Permian Basin*, *supra*, 390 U.S. at 767. It cannot on this record be gainsaid that FERC's rate of return on equity determination may reasonably be expected to maintain NEP's financial integrity while providing appropriate protection to the relevant public interests, both existing and foreseeable. *Permian Basin*, *supra*, 390 U.S. at 792. FERC's rate of return on equity determination must therefore be upheld.

C. *Rate Determination in R-8.*

In Opinion 49-A, FERC contrasted its evaluation of NEP's rate of return in R-8 with its evaluation in R-10. Because the former employed only NEP-operating information, it was not necessary in R-8 to deduce NEP-operating's rate of return from NEP-composite's value as was done in R-10. NEP argues that the R-8 determination was actually based on NEP-composite data and therefore the R-10 methodology should be applied to R-8.

Neither NEP nor FERC point to definitive support in Opinion 803 for their respective views regarding the methodology employed in R-8. The repeated distinction in Opinion 803 between NEP and NEES data, and the specific exclusion therein of the Yankee investment from NEP's common equity, are, however, consistent with FERC's view that only NEP-operating information was employed in R-8.

As noted above, one who seeks to overturn a FERC determination bears a heavy burden of demonstrating error therein. *FPC* v. *Hope Natural Gas*, *supra*, 320 U.S. at 602. NEP has not met that burden. Indeed the evidence to the contrary is more convincing. Accordingly, we affirm FERC's rejection of NEP's suggestion that the R-8 rate of return determination be subjected to the method employed in R-10.

(6) *NEES Debentures*

The question in this section is whether FERC, in Opinion 49, properly rejected the Committee's proposal to adjust NEP's capital structure to reflect proceeds of a NEES-issued debenture.

The proposed debenture adjustment rests on the contention that about $30 million of NEP equity was derived from debentures issued by NEES, at an interest rate of 3.25%. The Committee argues that that portion of NEP's equity should be treated as long term debt for ratemaking purposes. FERC viewed that argument as directed to the sources of funds invested by NEES in NEP equity, and noted that NEES' 3.25% interest cost was well below the 9.26% cost ascribed to NEP's common equity.

The ALJ, in originally denying the proposed adjustment, observed that the meagre and conflicting testimony on the source of the funds is subject to varying interpretations. In commenting on the Committee's proposed adjustment, FERC stated its intention to use NEP's (not NEES') capital structure where NEP's structure would produce a reasonable end result, and indicated that any adjustment based on NEES' debt holding would require a compensating adjustment to reflect NEES' expenses. FERC found the record inadequate to establish that adjustment but concluded that the net effect of the proposed adjustment to NEP's capitalization "would not be substantial," and rejected the proposal.

FERC's rejection of the proposed adjustment must be upheld: (1) the Committee cites no precedent for its proposed methodology; (2) FERC's overall capital structure determination is reasonable and based on substantial evidence in the record; (3) FERC's factual assumption on sources of capital structure violates no statutory mandate; (4) that assumption is not arbitrary, ca-

pricious, or an abuse of discretion, *New Mexico, supra,* at 18; and (5) FERC's approach to determination of capital structure should not be judicially reversed in favor of another that produces substantially the same result. *Indiana Municipal, supra.*

(7) *Narragansett Tax Expense*

The Narragansett tax expense arose from application of liberalized tax depreciation to generating facilities of Narragansett Electric Company (Narragansett), a retail affiliate of NEP. Those generating facilities, during the early 1970's, passed the so-called "cross-over" point and straight line book depreciation thereafter exceeded the depreciation available for tax deduction purposes. Before 1967, Narragansett used the facilities primarily in intrastate service, selling their output at rates set by the Rhode Island Division of Public Utilities and Carriers (Division). Those rates resulted in a flow through of the liberalized depreciation benefit to Narragansett's Rhode Island customers.

In 1967, Narragansett and NEP entered an agreement under which NEP controlled Narragansett's generating and transmitting facilities and supplied all of Narraganset's power requirements. In effect, NEP rented Narragansett's generating and transmission facilities, paying rent in the form of a credit on the monthly purchased power bill it submits to Narragansett. The rent becomes a part of NEP's overall wholesale or "interstate" cost of service; and all NEP customers, including Narragansett, pay a proportionate share of the rental amount. The agreement had the effect of integrating Narragansett with NEP as a supplier of power to customers both intrastate and interstate.

In a recent retail rate case, Narragansett sought to allocate to its retail customers the additional tax expense arising from an excess of book depreciation over

guideline tax depreciation.[27] Narragansett claimed that its retail customers in Rhode Island had derived benefits from a flow-through during the earlier period when its facilities were dedicated to intrastate service. The Division rejected the requested allocation, but held that the portion of increased tax expense attributable to facilities actually providing intrastate service was properly

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[27] Depreciation is the recognition of continued loss to property resulting from wear and tear, and technological obsolescence, which eventually lead to the retirement of that property. The amount of depreciation experienced annually may be reflected as a deduction from income for tax purposes.

The IRS permits depreciation of some property on an accelerated scale, allowing depreciation in greater amounts early in the life of the property and in smaller amounts later on. The IRS also provides a guideline scale, setting depreciation for other property in constant amounts over the life of the property. More conservative than either of those scales may be the scale carried on the company's own books of account (book depreciation). The amounts by which accelerated exceeds guidelines, and guideline exceeds book, are called "additional tax depreciation."

IRS allows additional tax depreciation on property acquired after 1969 to be normalized. *See* 26 CFR § 1.167(1). That is, for rate-making purposes, a utility may treat additional tax depreciation as though the tax deduction for that amount did not exist and may compute the amount of tax that would be owed if the deduction were income, adding to the cost of service the hypothetical tax resulting. The cost of service, and the rates charged to customers are thereby artificially inflated. The effect of this accounting procedure is to collect from current ratepayers those taxes which will not, in fact, become due until some future date and thus to spread the tax burden more evenly among present and future customers of the utility.

On the other hand, additional depreciation on property acquired before 1970 is treated as a flow-through item. That is, the tax deduction to which the company is entitled for depreciation is reflected currently in the company's tax calculations and this tax benefit is thus passed on immediately to the consumer in the form of lower rates.

allocatable to Narragansett's intrastate operations. *Re Narragansett Electric Co.*, Docket No. 1172, slip op. at 38-39. (R.I. DPUC 1975), *aff'd sub nom., Narragansett Electric Co.* v. *Harsch*, 117 R.I. 395, 368 A.2d 1194, 1204-06 (1977). The Rhode Island Supreme Court affirmed that decision as being within the Division's discretion. 368 A.2d at 1205-06.

Thereafter, NEP attempted to allocate the non-allocated interstate portion of the additional tax expense arising from the excess of book over guideline depreciation to its interstate operations in the R-10 proceeding, relying on the integration of Narragansett's facilities with NEP's wholesale power supply system serving all NEP customers. NEP also maintained that its inability to allocate all of the tax expense to intrastate operations, among other factors, made equitable the allocation of the remaining tax expense to interstate operations.

In Opinion 49, FERC rejected NEP's proposed allocation, citing NEP's pre-1967 normalization of the tax effect of the difference between book and guidelines depreciation of Narragansett's facilities. Under that normalization, NEP's interstate wholesale customers did not benefit from the additional tax deduction when guideline exceeded book depreciation. FERC reasoned that it would be inappropriate for interstate wholesale customers to be burdened with additional expense when the tables were turned and book exceeded guideline depreciation. Asserting that the increased tax expense should be treated as any other cost of service item associated with NEP's interstate service, NEP says FERC's reliance on the past allocation method is an abuse of discretion, resulting in a patently inequitable situation in which NEP is unable to recover the additional tax expenses from either wholesale or retail customers.

NEP cites no support for its assumption that FERC lacks authority to consider previous related incomes and

sources in determining the proper treatment to be given current liabilities and expenses. NEP further assumes that FERC's lack of discussion of several grounds cited in support of NEP's position affirmatively demonstrates a failure to consider those grounds. Neither assumption has merit. We cannot fault FERC's allocation of increased tax expense to NEP, which had reaped the benefits of the corresponding tax credit. FERC reached that result on undisputed evidence concerning the dollar amounts and allocation of service between wholesale and retail customers. As noted above, FERC is not bound to the service of any single methodology. *FPC* v. *Natural Gas Pipeline Co., supra; FPC* v. *Memphis Light, Gas and Water Division,* 411 U.S. 458 (1973). We find no basis for overturning FERC's resolution of the tax expense allocation issue.

(8) *Inclusion of Bond Issue in NEP's Capital Structure*

The question in this section is whether FERC confused actual with estimated data in approving NEP's capital structure. NEP acknowledges that it included a $50 million bond issue in its estimate of year-end (December 31, 1976) capital structure, but notes that the bonds themselves did not issue until January 27, 1977, five days before the rate period ended. NEP contends that FERC intended to approve a capital structure based only on actual data as of December 31, 1976, which would not have included the bonds issued. Alternatively, NEP contends that if inclusion of the bonds was intended, the inclusion is arbitrary and irrational because it does not accurately reflect the cost of capital and interest expense deductions available during the period the rate was in effect.

In Opinion 49, FERC indicated that it was using "NEP's actual capital structure as of December 31, 1976 *adjusted* to reflect [its] determination on deferred taxes,

the Yankee investments, the NEES debentures, and the $50 million bond issue . . . ." (Emphasis supplied.) Thus it cannot be said that FERC, having "adjusted" the actual capital structure to reflect a number of items, including the bond issue, intended to approve a capital structure based only on actual data.

Nor can we agree that the inclusion of the bonds was arbitrary or irrational. NEP's arguments are an attempt to abandon its original estimate, which included the bond issue, in favor of actual data which did not. As indicated above, use of estimated data, once substantiated, is proper unless the estimate was unreasonable when made, or where subsequent events would cause the estimates to yield unreasonable results. *Indiana Municipal*, supra at 485. NEP has made no such showing. Accordingly, FERC's inclusion of NEP's bond issue in capital structure must be affirmed.

(9) *Consolidated Tax Benefits*

The question presented here is whether FERC erred in ignoring tax benefits associated with the NEES debenture. In so claiming, the Committee envisions a benefit to consumers of $794,000.

In his original determination, the ALJ identified a tax savings to NEP of $794,000 arising out of the consolidated tax return filed by NEES.[28] To conform NEP's authorized tax expense, the ALJ suggested elimination of the excess.

In its Opinion 49, FERC purported to resolve the matter in summary fashion, stating:

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[28] Although the ALJ's opinion did not directly attribute the consolidated tax benefits to the NEES debenture, FERC does not contest the Committee's assertion that the debenture was the source of those benefits.

> NEP is directed to revise its calculations on this issue in accordance with *Columbia Gulf Transmission Company, et al.*, Docket Nos. RP75-105 and RP75-106, Opinion No. 47, issued July 2, 1979.[29]

Although FERC and the Committee disagree here on the impact of *Columbia Gulf* on the present facts, FERC has chosen to apply an interpretation denying the consumer any benefits from the alleged consolidated tax savings.

In *City of Charlottesville, supra*, n. 29, this court remanded FERC's determination in *Columbia Gulf* because the order in that proceeding denied the consumer any benefit of a tax saving on the basis of a purported investment incentive effect, which effect was without the support of substantial evidence in the record. Nothing presented in the case before us fills the evidentiary void that required remand in *City of Charlottesville*, or in any manner supports FERC's benefit-denying interpretation in light of the ALJ's determination.

FERC allocated consolidated tax savings to shareholders in *Columbia Gulf* because those savings were generated by exploration and development investments, and because a need exists to encourage such investments. Remand was necessitated by the lack of evidence that such allocation would produce such investments. Nothing of record here indicates that the present tax savings were generated by such investments, or that allocation of those savings to shareholders would produce such investments. Accordingly, we remand to FERC the question of allocation of consolidated tax savings.[30]

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[29] Remanded *sub nom. City of Charlottesville, Va.* v. *FERC* (D.C. Cir. No. 80-1175), August 7, 1981.

[30] The Supreme Court in *FPC* v. *United Gas Pipeline Co.*, 386 U.S. 237 (1967), declared that FERC's predecessor had the authority to take into account consolidated tax savings from any source, and that there is no specific treatment mandated for allocation of consolidated tax savings. Remand is

(10) *Subtransmission Expenses*

NEP contests FERC's allocation of certain substransmission expenses in light of certain settlement agreements, contending for an opportunity to recover costs not recovered as a result of a settlement agreement filed in an earlier rate proceeding (R-9).[31] The ALJ described the situation:

> It appears that this rate design dispute has resulted, in part, from varying interpretations of the R-9 Settlement Agreement, in which it was stipulated that the former monthly surcharge of 46¢ per kilowatt for subtransmission service would be reduced to 5¢.

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required, however, when the record, as here, is void of evidence or rational articulation supporting the treatment selected.

[31] Article II of the settlement agreement (Docket Nos. E-9136 and E-9140) approved by FERC on July 12, 1976, reads:

Supplemental Charge

2.1 In its Rate R-10 filing of November 25, 1975, NEP tendered tariff sheets which sought to raise the charge for service in connection with delivery at other than Standard Delivery Point from 5¢ per kw of demand to 46¢ per kw of demand. Said increased charge is due to become effective as of March 1, 1976. The Company agrees to file a revised tariff sheet which reduces this charge from 46¢ per kw of demand to 5¢ per kw of demand and to request an effective date of March 1, 1976, for such reduction.

2.2 The Company further agrees that it will not increase this charge prior to January 1, 1977. It is understood and agreed that the Company may submit for filing a proposed increase in such charge and may request a proposed effective date prior to January 1, 1977, provided that the Company requests suspension of the increase until January 1, 1977.

2.3 No moratorium whatsoever is here intended in regard to the Company's rates other than its charge for delivery at other Standard Delivery Point.

> NEP contends that by agreeing to this reduced surcharge, it did not agree to forego recovery of the full amount of the lease costs it has incurred as the result of use of Mass Electric facilities. Thus, NEP's proposed revised rates are designed to charge the deficiency between this cost and the proceeds from the 5¢ surcharge, against all NEP customers, whereas [Committee] would charge this deficiency against only subtransmission customers. This [Committee] proposal would have the effect of a second or an additional charge against Mass Electric customers.

FERC viewed the omission of any provision in the R-9 settlement agreement on substransmission expenses not recovered by the surcharge as a waiver of those expenses. NEP argues that the R-9 settlement was limited to setting the surcharge and has no effect on its right to recover its additional substransmission expenses, pointing to an earlier settlement agreement (R-5) on substransmission expenses which included a specific clause waiving NEP's recovery of the remaining expenses.

Though the interpretation of the agency which approved the settlement cannot be discounted, that interpretation must have some rational basis beyond a mere omission of a clause to the contrary. The question here is one of contract interpretation, a function peculiarly within the expertise of courts. Interpretation of the R-9 settlement contract on this appeal, however, is precluded by the absence from the record of the circumstances and acts of the parties in the making and performance of that contract. At the same time, to affirm the administrative interpretation on the present record would be to substitute judicial abdication for judicial review. *See National Labor Relations Board* v. *Truck Drivers, etc.*, 630 F.2d 505, 507 (7th Cir. 1980); *cert. denied sub nom., Gilmer* v. *Truck Drivers, etc.*, —— U.S. —— 101 S. Ct. 1740 (1981); *Northwest Publications Inc.* v. *National*

Labor Relations Board, No. 80-7459 (9th Cir. September 14, 1981). Accordingly, we vacate FERC's determination on NEP's subtransmission expenses and remand that question for further consideration.

(11) *Tax Normalization*

As noted above, FERC was directed by this court's remand order in R-8 to reconsider the tax normalization issue in light of this court's previous opinion in *Public Systems* v. *FERC*, *supra*. FERC admits, however, that it did not on remand decide that issue, because normalization rulemaking was still pending, and that it did not, as a consequence, determine the remanded issue of the justness and reasonableness of finally allowed rates in the light of its conclusions on normalization.

Precluded from review of an inchoate tax normalization determination, and of its effect on the justness and reasonableness of the overall rate of return, we remand those issues to FERC.[32]

CONCLUSION

FERC's determinations respecting cancelled project expenditures, investment tax credit funds, interest deduction, test year estimates and adjustments, rate of return on common equity, NEES debentures, Narragansett tax expense, and inclusion of the bond issue in NEP's capital structure, are affirmed.

FERC's determinations respecting consolidated tax benefits, substransmission expenses, and tax normalization are remanded.

Modified.

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[32] FERC is not precluded from revision of the determinations here affirmed, to the extent and if those determinations are necessarily affected by conclusions reached on the remanded issues.

APPENDIX B

ORDER OF U.S. COURT OF APPEALS DENYING REHEARING

(Filed November 24, 1981)

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

SEPTEMBER TERM, 1981

No. 80-1343
ARGUED 6-22-81

NEPCO MUNICIPAL RATE COMMITTEE
and the ELECTRIC DEPARTMENTS and
PLANTS OF ASHBURNHAM, *et al.*

Petitioners

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

NEW ENGLAND POWER COMPANY
DENNIS J. ROBERTS, II, ATTORNEY
GENERAL OF RHODE ISLAND,

Intervenors

and consolidated cases

BEFORE: Tamm And Wald, Circuit Judges And Howard T. Markey*, Chief Judge, United States Court Of Custom And Patent Appeals

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*Sitting by designation pursuant to Title 28 U.S.C. § 293(a).

ORDER

On consideration of the petition of the New England Power Company for rehearing for purposes of clarification, it is

ORDERED by the Court that the aforesaid petition is denied.

Per Curiam

FOR THE COURT:

George A. Fisher,
Clerk

/s/ ROBERT A. BONNER
Robert A. Bonner
Chief Deputy Clerk

APPENDIX C

OPINION OF THE FEDERAL ENERGY REGULATORY COMMISSION

(Issued July 19, 1979)

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

OPINION NO. 49

NEW ENGLAND POWER COMPANY	) DOCKET NOS.	ER76-304
	)	ER76-317
	)	ER76-498

OPINION AND ORDER
ESTABLISHING JUST AND
REASONABLE RATES

Issued: July 19, 1979

DC-B-26

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

DOCKET NOS. ER76-304
ER76-317
ER76-498

NEW ENGLAND POWER COMPANY

OPINION NO. 49

APPEARANCES

Leonard W. Belter, Thomas M. Debevoise, William J. Madden, Samuel Huntington, and *William G. Hayes* for New England Power Company

Thomas N. McHugh, Jr., Daniel I. Davidson, and *Robert C. McDiarmid* for Unaffiliated Resale Customers

R. Daniel Prentiss for Rhode Island Division of Public Utilities and Carriers and Rhode Island Consumers' Council

Dennis J. Roberts, II, for Rhode Island Consumers' Council

Charles Gamer for the Attorney General of the Commonwealth of Massachusetts and the Massachusetts Consumers Council

Cyril S. Wofsy, Barbara J. Weller, and *Lilo Schifter* for the Staff of the Federal Energy Commission

ELECTRIC RATES: RATE OF RETURN; COST OF SERVICE; RATE DESIGN; RATE BASE; EXTRAORDINARY PROPERTY LOSS

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Charles B. Curtis, Chairman; Don S. Smith*, Georgiana Sheldon
Matthew Holden, Jr., and George R. Hall.

NEW ENGLAND POWER COMPANY

DOCKET NOS. ER76-304
ER76-317
ER76-498

OPINION NO. 49

OPINION AND ORDER ESTABLISHING JUST AND REASONABLE RATES

(Issued July 19, 1979)

I Nature Of Proceeding

These proceedings before the Commission [1] concern changes in rates filed by New England Power Company (NEP),

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* Commissioner Smith resigned effective June 29, 1979. He was present and voting when this order was approved at the meeting of June 13, 1979.

[1] This proceeding was commenced before the Federal Power Commission (FPC). By the joint regulation of October 1, 1977 (10 CFR [illegible].1), it was transferred to the FERC. The term "Commission," when used in the context of action taken prior to October 1, 1977, refers to the FPC; when used otherwise, the reference is to the FERC.

a wholly-owned subsidiary of NEES (New England Electric System).[2] On November 28, 1975, NEP filed in Docket No. ER76-304 its R-10 proposal. As filed the R-10 proposal would increase rates applicable to its wholesale electric customers by about $39.8 million per year above the revenues NEP expects to receive under the R-9 settlement rates. On December 1, 1975, NEP filed in Docket No. ER76-317 a proposed new R-10/CD rate, relating to contract demand (CD) service. This proposal is designed to increase NEP's revenues by about $764,300 per year from customers receiving this service. On January 30, 1976, NEP filed in Docket No. ER76-498 certain revised tariff sheets pertaining to NEP's service to its affiliate, Narragansett Electric Company (NARR). By orders issued December 31, 1975, February 17, 1976, and February 27, 1976, the Commission, among other things, suspended the effectiveness of the proposed changes until March 1, 1976, and consolidated all three proceedings for hearing.[3]

In addition to Staff and NEP, other parties in this proceeding include the NEP Municipal Rate Committee (MRC or Customers),[4] Rhode Island Division of Public Utilities and Carriers and the Rhode Island Consumers Council (RI), and the Commonwealth of Massachusetts and the Massachusetts Consumer Council (Mass).

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[2] NEES is an integrated electric holding company which serves portions of Massachusetts, Rhode Island, and New Hampshire.

[3] The instant proceedings are for a "locked-in" period (March 1, 1976 to February 1, 1977).

[4] The customers are the electric departments and plants of the following Massachusetts towns and cities: Ashburnham, Boylston, Danvers, Georgetown, Groton, Hingham, Holden, Hudson, Hull, Ipswich, Littleton, Mansfield, Marblehead, Merrimac, Middleton, North Attleboro, Paxton, Peabody, Princeton, Shrewsbury, Sterling, Templeton, Wakefield, and West Boylston, together with Littleton, New Hampshire, Manchester Electric Company, and New Hampshire Electric Cooperative.

Hearings in these proceedings were commenced on January 11, 1977 and completed on March 25, 1977. The Presiding Administrative Law Judge (Judge) issued his initial decision (ID) on June 30, 1977. Briefs following the Judge's initial decision were completed in November, 1977.

II Issues In Contention

The major issues in these proceedings include: (1) rate of return; (2) the proper treatment of the extraordinary property loss (Salem Harbor project); (3) the proper tax treatment with regard to the Narragansett generation and transmission credit; (4) rate design; (5) cost of service calculations; and (6) rate base.

III Rate of Return

The most significant issue here concerns the allowance on common equity in computing the rate of return. We will deal with this issue first and then turn to certain capital structure issues which have been raised.

The Judge found a return on common equity of 13.5% to be just and reasonable. This finding appears primarily based on his conclusion that the relevant factors considered by the Commission in arriving at a 13.5% return on common equity in Opinion No. 803 (R-7 and R-8 proceedings)[5] are not materially different from the factors bearing upon rate of return in this R-10 proceeding (Id. at 12). Further, he contended that using rate of return methodologies which rely on fluctuating market prices can be dangerous (Id. at 10) and therefore he apparently ignored most of the expert testimony of record. All parties objected to

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[5] Opinion No. 803, *New England Power Company*, Docket Nos. E-8641 *et al.*, issued June 6, 1977, concerned two rate increase filings for two successive locked-in-periods, January 1 to May 14, 1974 (R-7) and May 15, 1974, to June 1, 1975 (R-8).

the Judge's decision on, among other things, one or both of the above two grounds. We agree with the parties that conditions reflected in the R-10 period are significantly improved from the R-7 and R-8 periods.[6] Further we have recently stated that we are interested in market oriented rate of return analyses.[7] In light of the above, and based on our analysis of the record discussed below, we reverse the Judge and find a return on common equity of 13.12% to be just and reasonable.

Table 1, *infra*, summarizes the recommendations of the seven rate of return witnesses and the basic approaches they used to arrive at their findings. The table also shows that the final recommendation of most of the witnesses explicitly embody various adjustments to estimates of the return required by common equity investors (the market required rate of return). These adjustments are intended to reflect such factors as issuance and market pressure costs associated with new stock sales and other add-on allowances to permit NEES (proxy for NEP) to achieve prespecified market to book (M/B) ratios for safety and other reasons. Two witnesses, Messrs. Wilson and Hutt, gave no indication as to which, if any, of these factors were incorporated in their recommendations.

Before proceeding to evaluate the presentations of the witnesses, we note that all 7 rate of return witnesses have looked to NEES as a proxy for NEP in their respective analyses. Upon our review of the record, however, we find that none of the witnesses considered the implications of NEP's relationship to the Yankee generating companies. We are concerned about this because of our understanding that (1) the existence of cost-of-service tariffs between NEP and the Yankee companies significantly reduces the level of risk to the Yankee companies (by

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[6] See, for example, Appendix C of this Opinion.

[7] Opinion No. 12, *Minnesota Power and Light Company*, Docket No. E-8494, issued April 14, 1978, (mimeo at 10-11).

Table 1

Witness & Sponsor	Derivation Methods [1]	Return Required by Common Equity Investors	Recommended Equity Rate of Return, Including, if any, Allowances for Market Pressure and/or Issuance Costs and/or Other Cushions [2]
Benderly (NEP)			
- Initial Presentation	M/B of 1.1	13. 49	14.6
- Revised Presentation [3]	M/B of 1.1	12.53	13.7
	M/B of 1.18	12.53	14.6
Meyer (NEP)			
- Initial Presentation	DCF; RP; M/B of 1.2	13.625	15.5
- Revised Presentation [3]	DCF; RP; M/B of 1.2	12.5	14.24
Noyes (NEP)	DCF; RP; CE	12.2 [4]-13.8	14.7 [5]
Rose	DCF; RP	12.93	13.93
Miller (MRC & MASS)	DCF	11.21-11.88	11.75
Wilson (MRC)	CE		11.0-12.0 [6]
Hutt (STAFF)	CE		13.0 [6]

[1] The method symbols have these meanings:

DCF = Discounted Cash Flow approach.

M/B = A methodology based on determining a recommended equity rate of return that would achieve a prespecified market-to-book ratio.

RP = A risk premium methodology intended to derive the required equity rate of return as a premium over the required rate of return for some less risky security.

CE = Traditional Comparable Earnings presentation.

[2] See footnote *14, infra,* where Mr. Meyer summarizes most of NEP's rationale for all these allowances.

[3] Values shown are the revised figures based on data more relevant in time to the locked-in period in this proceeding.

[4] The 12.2% figure reflects the result in Mr. Noyes' third DCF calculation before an addition is made to reflect an adjustment for market pressure and issuance costs.

[5] The 14.7% figure includes a 1% cushion (or margin of safety) which Mr. Noyes added to his 13.7% average of his 8 estimates (see Appendix B of this opinion).

[6] Witnesses Wilson and Hutt made no explicit finding on the return required by equity investors. Nor did they make any explicit allowance for market pressure, or other issuance costs of issuing new equity, or any other cushions.

shifting some risk to NEP) and (2) the Commission-set rates of the Yankee companies are generally based upon this lower risk level. Fairness would seem to require that the rates set for NEP in this proceeding reflect the higher risk created by the cost-of-service tariff.

In evaluating this issue, we begin by noting that of NEP's total common equity investment ($289.0 million), some $34.2 million is invested in the Yankee generating companies while the remainder ($254.8 million) is invested at the operating company level. We can thus view NEP as a composite of two separate investments which we shall refer to as NEP-Yankee and NEP-operating company. The instant proceeding is concerned with setting rates for the latter. In doing so, we must determine the appropriate rate of return to allow on NEP-operating company's common equity commensurate with its risk especially as this risk is affected by the cost-of-service tariff arrangement between NEP-operating company and NEP-Yankee.

A critical factor here is the dual nature of NEP's relationship to the Yankee companies. It is both an owner and a customer of each of the Yankee generating companies. As a result, the existence of the cost-of-service tariff serves simply to shift risk from what we have referred to as NEP-Yankee to NEP-operating company. In other words, the return on the common equity invested in the Yankee companies becomes less risky while the return on the common equity invested in NEP-operating company becomes more risky. The risk of NEP as a whole (the composite NEP), however remains unchanged.

Turning now to the use of NEES as a proxy, we find it reasonable to presume comparability in risk between the consolidated NEES and the composite NEP. Since NEP is essentially the generating arm of the NEES system serving the predominant portion of the other subsidiaries' loads, there is good reason to associate the risks of NEP as a whole with the

risks of NEES. As the sales (and, thus, earnings) of the other subsidiaries vary over time so also do the sales (and earnings) of NEP. Thus, it seems reasonable to use the estimated cost of common equity to NEES as a proxy for the cost to the composite NEP. However, because of the Yankee affiliation considerations discussed above, once we have made a determination of the cost of common equity to the composite NEP, we must then adjust it upward for purposes of this proceeding to reflect the shift in risk to NEP-operating company from NEP-Yankee as a result of the cost-of-service tariff.

We do not wish to suggest that this is a major factor in our ultimate determination or that, whenever proxies are used in the estimation of the cost of common equity, adjustments must always be made to the estimated values. In the instant proceeding, we have a situation where there is obvious merit in such an adjustment. The intent is to make our treatment of the separate entities consistent and to provide NEP the opportunity to realize a just and reasonable return on the whole of its invested capital.

A. NEP Position

NEP contends that it is entitled to a 14.6% return on common equity. NEP presented four rate of return witnesses on this subject, Messrs. Benderly, Meyer, Noyes and Rose.

Mr. Benderly, NEP's primary rate of return witness, used a statistical model[8] to determine the return on common equity

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[8] See Exhibit 8. Also see Tr. 230 where Mr. Benderly describes his model as follows:

> The statistical model relates the price-book ratios of [94 electric utilities listed on the New York Stock Exchange] to various characteristics of the companies, including their rates of return on common equity. This gives rise to an equation which explains differences in the price-book ratios of the utilities in terms of the differences among them in their rates of return and other relevant characteristics. There is a very good fit to the data considering the fact that we are attempting to explain what is happening to stock market prices in a period of considerable disruption. Having derived an equation which tells us the relationship between the price-book ratio and the rate of return on common equity,

NEES should be allowed to earn in order for its common shares to achieve a market price to book value per share ratio (M/B ratio or price-book ratio) of 1.1 to 1. The rationale for this 10% premium over book value is to allow the company's common stock to sell for a price at least moderately above book value so that the company can sell more shares without fear of diluting the equity of existing shareholders (Tr. 229). Mr. Benderly testifies that the return required to bring the market price of a stock into equality with its book value is generally what the economist defines as "barebones" cost of common equity capital (Tr. 229).

As explained in footnote 8, the product of Mr. Benderly's statistical analysis is an equation which express M/B ratio as a function of 7 variables[9] which, he feels, best explain the differences in M/B ratios among the 94 utilities studied. Using this equation Mr. Benderly finds that the equity return required by

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we can then determine for any given company what its rate of return would have had to have been, in order for the price-book ratio to equal 1.0 or 1.1 (or any specified number).

In this model, the dependent variable which I was trying to explain was the recent price-book ratio. The measure I used was the average of the closing prices for January through September 1975, divided by book value per share as of year-end 1974. The price-book ratios were thus calculated for the 94 electric utilities listed on Schedule 8 of my exhibit, and the statistical problem was to explain the differences among the companies.

I considered and tested a total of 46 variables which might affect price-book ratios; the list of all the variables considered appears on Schedule 9 of my exhibit. Using stepwise regression techniques I arrived at the following list of variables which provides the best fit to the data — i.e., they provide the best explanation of the differences in price-book ratios among the 94 utilities. If other variables are added to this list they prove to be statistically insignificant in their effect on the price-book ratio once these factors are included.

[9] The seven variables are: the 1974 rate of return on common equity; the square of the 1973 rate of return on common equity; the square of the 1975 rate of return on common equity as estimated in May 1975 by Value Line; allowance for funds used during construction (AFDC) as a percent of reported earnings in 1974; oil as a percent of fuels consumed in 1974; use of flowthrough accounting for liberalized depreciation; and the ratio of dividends to cash flow in 1974 (See Tr. 230-231).

NEES to bring its market price into equality with its book value per share is 13.49% and that an equity return of 14.6% would be required for the market price to be 10% above book value (Tr. 232). This study used the average of closing prices for January through September 1975 divided by book value per share as of the end of 1974.

In his updated study (Item by Reference B) the M/B ratio was derived using the average of closing prices for October, 1975 through June 1976 divided by book value per share as of the end of 1975. Using this more recent data Mr. Benderly finds that the equity return required by NEES to bring its market price into equality with its book value per share is 12.53% and that an equity return of 13.7% would be required for the market price to be 10% above book value (Tr. 236). However, Mr. Benderly still concludes that an allowed rate of return of 14.6 (which implies a market price 18% above book value) would not be excessive (Tr. 237).

We appreciate Mr. Benderly's stepwise regression analysis as a valid statistical technique, but we are unable to discern a sound economic or financial theory as a basis for his specific formulation, and this, we believe, severely lessens the credibility we can attach to his method. We recognize that when one is concerned simply with forecasting values for a dependent variable without fully understanding how independent explanatory variables play a role, then this issue is frequently ignored. In our view, however, the equity return estimation is not such a purely forecasting exercise. Consequently, the chief potential danger of employing an approach like Mr. Benderly's is the real possibility of using a framework which may not be consistent with relationships that can in fact be demonstrated. [10] For exam-

[10] NEP's own witness, Mr. Rose, also indicates the need for substantial caution when evaluating mathematical models (Tr. 349-350). He points out that simply because a correlation exists with regard to certain variables, this does not prove the existence of a causal relationship between the variables being tested. He further points out that statistician's explanations "may tend to focus on statistical 'proofs' rather than intuitive (common sense) reasoning (Tr. 351).

ple, the importance of bond ratings was not among the 46 independent variables considered by Mr. Benderly in his initial presentation. Yet in his rebuttal testimony, he identifies bond ratings as "financial factors which might reasonably be taken into account by investors in formulating their risk assessments" (Tr. 240). [11] Indeed, bond ratings are at the heart of Mr. Meyer's determination of differences among electric utilities with respect to common equity capital risks. In summary, Mr. Benderly's approach, although systematic in its development, appears to be unsupported in its fundamental causality premise.

NEP witnesses, Meyer, Noyes and Rose each presented testimonies that, among other things, rely explicitly on DCF analysis, as *Table 1* shows. All three have used the familiar (Dividend Yield) + (Growth Rate) form, with Mr. Meyer's incorporating it as one step in a sequential analysis, while Messrs. Rose and Noyes use it as an overall framework. [12]

Mr. Meyer computes for each firm in a sample of twenty-two (mostly electric) utility companies over different timespans the (a) average annual dividend yield value and (b) compound annual growth rate for earnings per share which he sums to obtain a "total return" value for equity. He then tabulates for the same timespan the Moody's average yields for bonds that were rated similarly to the company being examined and computes a simple arithmetic mean of those numbers as an "average yield." The differential between this latter value and his "total return"

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[11] Mr. Benderly adds the factor of bond ratings to his 44 independent variables considered in his updated revised presentation. However, while we do not wish to preclude Mr. Benderly from improving his study, our confidence in his methodology is not enhanced by the fact that his list of independent variables changes from study to study (Compare Exhibit 8 with Item by Reference B. See also Tr. 808-811).

[12] Mr. Noyes actually presents eight equity rate of return estimates, three of which use the DCF approach, three of which employ variants of the premium-for-equity-risk notion, and two other approaches (See Exhibit 48).

value he considers to be a measure of equity risk premium. He finds for his sample of firms that these differentials range between 3% and 5%. When these differentials are added to a prevailing utility bond interest rate of 9.625% [13], his estimates of minimum required return by equity investors results in a range of 12.625% — 14.625%.

Based on his additional assumption [14] that the allowed return on common equity should result in a market price 20% above book value, Mr. Meyer calculates the required return on equity to be in a range of 14.4% to 16.7% and recommends 15.5%.

MRC, RI, and MASS all point out that Mr. Meyer's bond/equity differential of 3-5% is based on data weighted primarily in the 1960's and that if he had included the periods of lesser earnings growth in the 1970's, the result would reflect a smaller equity premium (or bond/equity differential) than that shown in Exhibit 37. Mr. Meyer even admits as much when he states, with reference to Exhibit 37, that "[i]n these studies, we

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[13] Mr. Meyer's judgment as of late summer to early fall of 1975 is based on AA/Aa bond ratings. (Tr. 391 and 1676)

[14] The rationale for Mr. Meyer's 20% premium M/B is explained as follows:

> This is required because the announcement of a new common stock sale usually results in a downward *market pressure* on the stock price, reflecting expected earnings per share dilution. In addition, between the time of announcement and time of sale, there needs to be some *cushion* to protect against market declines caused by factors unrelated to the issuing company itself. For example, such factors could include outbreaks of war in different parts of the world, political upheaval in other countries or this one, another Arab oil embargo or a dividend omission by a major corporation. Finally, the *costs of doing the financing itself [or issuance costs]*, i.e. the underwriting spread and the payment to legal firms will also reduce the net proceeds to the Company. It is, therefore, desirable for utility stocks to sell at least 20% higher than book value in order to guard against these pressures (Tr. 390). (emphasis added)

At the risk of being redundant we point out that the numerical value (20% premium M/B ratio) is obviously, conjectural.

selected periods where the common stock of the companies sold at premium prices to book value. In addition, the periods selected were ones exhibiting moderate but steady earnings per share growth" (Tr. 390).

Mr. Meyer's updated presentation (Exhibit 86) reflects a prevailing AA utility bond interest of 8.50% as of January 1977. To this he adds 4% (mid point of the 3-5% bond/equity differential). The result is 12.50% minimum required by the equity investor. Mr. Meyer then computes an equity return figure of 14.24% based on his recommendation that market price reflect a 20% premium over book value per share.

Mr. Noyes, NEP's third rate of return witness, presented 8 separate methods for estimating NEES' cost of common equity. These are summarized in Exhibit 48.[15] Mr. Noyes did not specifically recommend any one of his eight methods. Rather he computed an average of the 8 estimates of 13.7%. To the 13.7% figure he added 1% as a margin of safety in case NEP is unable to earn its allowed rate of return (Tr. 426-427). Thus his final recommendation is 14.7% and this figure includes allowances for market pressure, issuance costs, and a 1% margin of safety factor.

We note that Mr. Noyes, in addition to his 8 methods summarized in Exhibit 48, also did a DCF calculation for NEES alone (Tr. 422). Based on a least squares growth rate in earnings for NEES (for the 1956-1975 period) of 4.14% and a daily average yield for NEES over the one year time span ending September 30, 1976 of 8.5%, and an adjustment for market pressure and issuance costs of 10% of dividend yield, the result is 13.5%. Mr. Noyes characterizes this as reasonably close to the 13.9% average of his three DCF methods contained in Exhibit 48.

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[15] See Appendix B of this Opinion.

Mr. Rose, NEP's fourth rate of return witness, presented a DCF method for NEES only (Exhibit 82) based on a dividend yield of 8.98% as reflected in the first 11 months of 1976 and a growth rate of 3.95%. The growth rate used is the average of the 10 year growth rate in earnings and dividends per share. Thus, Mr. Rose's result, taking into account the first 11 months of 1976, is 12.93%. Mr. Rose then makes an adjustment of 10% to dividend yield to reflect market pressure and issuance costs. Mr. Rose's final recommendation is then 13.93% (Exhibit 82). Mr. Rose in Exhibit 82 also shows alternative calculations for NEES' cost of common equity using both 5 year and 20 year growth rates. His growth factor and overall recommended return based on the 5 and 20 year periods are 3.78% (13.6%) and 3.81% (13.79%) respectively.

B. Position Of MASS, RI, And MRC

All three intervenors support the rate of return on common equity testimonies of Mr. Miller and Dr. Wilson.

Mr. Miller's testimony can be divided into three main parts: (1) a DCF analysis[16] based upon a study of 88 electric utility companies which had operating revenues of at least $100 million in 1975; (2) an estimation of risk premium for NEES; and (3) an assessment of market pressure and issuance cost adjustments.

In part one of his testimony, Mr. Miller calculates the average cost of equity to his 88 company sample by summing the average current dividend yield (8.64%)[17] and the average

[16] Mr. Miller explains that in using the DCF method "it is necessary to determine the appropriate current dividend yield and to make an estimate of the growth factor representing investors' growth expectations." (Tr. 465).

[17] The dividend used is the indicated dividend published in the September, 1976 issue of Standard and Poor's *Stock Guide*. The price is based "on the average of the high and low for the first 8 months of 1976, taken from [Standard and Poor's *Stock Guide*]."

growth in tangible book value (2.53%-3.20%). The growth rate range, using tangible book value as a proxy for growth, reflects periods of two, three, five, and ten years ending in 1975 (Tr. 467). The two year growth rate (1973-1975) was .76%, the three year growth rate (1972-1975) was 1.83%, the five year growth rate (1970-1975) was 3.20%, the ten year growth rate (1965-1975) was 4.06%, and a weighted average of the above four growth rates was 2.53% (Exhibit 109).

We agree with Mr. Rose's contention in his rebuttal testimony that Mr. Miller's weighted average calculation gives excessive weight to the later years' growth rates (since they appear in all sequences considered) (Tr. 354). We also agree with Mr. Rose that much of the low growth for the years 1973-1975 is explained by the impact of the energy crisis and that the figures for 1976 reflect recovery for NEES and other utilities from the poor years of 1973-1975 (Tr. 354).[18] Even Mr. Miller indicates that, in his judgment, the 5 year growth rate figure of 3.20% is most closely reflective of current investor expectations (Tr. 472).

In the second (risk premium) part of his testimony, Mr. Miller does a statistical analysis of factors that contribute to differences in the cost of common equity capital among electric utility companies. He estimates a regression equation depicting current yield as a function of tangible book value growth rate and two[19] alleged risk-related variables. The two variables were common equity ratio and effective income tax rate. Using (a) NEES value and (b) average values from his 88-firm sample for these two risk-related variables, Mr. Miller deduces a cost of

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[18] See Appendix C of this opinion which reflects data from Item by Reference B of this proceeding as to the recovery by NEES and other utilities from the poor years of 1973-1975.

[19] Only two among the risk-related variables he considered proved to be statistically significant.

common equity capital for NEES that is .04% higher than the average cost of common equity for the 88 electric utilities in his study (Exhibit 109).

We do not find Mr. Miller's analysis for the .04% risk adjustment to be persuasive because he does not satisfactorily explain this adjustment. Further his technique appears to have some technical flaws. [20]

Adding the calculations from part one of his testimony to the .04% risk adjustment premium, Mr. Miller finds the cost of common equity to be in a range of 11.2% - 11.88%.

In the third part of his testimony, Mr. Miller makes an assessment of possible adjustments for market pressure and issuance costs as follows:

> Q. HOW DO YOU PROPOSE TO DETERMINE A PROPER ALLOWANCE FOR MARKET PRESSURE AND THE EXPENSES OF ISSUING COMMON STOCK?
>
> A. I begin by noting that NEES's annual requirements for issuing new common equity in public offerings are not likely to exceed 5 percent of the common equity balance at the beginning of the year. This result is consistent with that offered by Mr. Meyer at page 9 of his testimony, and it is buttressed by the downward revisions in load growth attitudes that have recently become apparent at NEES.
>
> I then estimate the costs associated with the issuing new common equity, including market pressure and expenses of issue. I find these costs to total no more than 3 - 7 percent. My final step is therefore to apply

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[20] For example, his analysis appears to ignore the estimated regression coefficient (which was less than one) on the growth rate variable since he uses the growth rate variable as it stands in his rate of return calculations. This suggests an inconsistency in his analysis which he does not satisfactorily explain.

> this cost rate of 3 - 7 percent to the 5 percent common issue requirement, and I conclude that the annual costs associated with new common equity issues for NEES are not likely to exceed 0.15 - 0.35 percent of the total book value of NEES's common equity. I therefore increase my estimate of the barebones cost of common equity for NEES by an amount that may be as large as 0.15 - 0.35 percent, to offset these costs. (Tr. 480). [21]

Our analysis of the testimonies of Mr. Miller and the 4 NEP witnesses concerning market pressure and issuance costs is found on pages 20-21 of this Opinion.

Dr. Wilson, the second intervenor witness, presented a comparable earnings analysis which finds that "returns on common equity in excess of 12% would not be required to attract capital or to fairly compensate the New England Power Company's common equity holders for their investments" (Tr. 451).

Dr. Wilson initially examined the actual earned returns on equity and the large operating subsidiaries of nine utility holding companies (Exhibit 96). [22] He also examined non-electric utility firms since he found that reference to only the utility industry was circular and that all firms must compete against each other for capital. His Exhibit 97 indicates that, in terms of

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[21] Of the 3-7 percent allowed for issuance costs and market pressure, Mr. Miller would ascribe 3-5% to issuance costs and 0-2% to market pressure (Tr. 481). His 3-5% figure for issuance costs is based, among other things, on data in Exhibits 140 and 141 and his 0-2% for market pressure is based, among other things, on a study by Myron S. Scholes, published in the 1973 *Journal of Business*. Mr. Miller states that the Scholes study "supports the proposition that market pressure is negligible, although the empirical results presented in this paper could also be interpreted to indicate that market pressure may cause a drop of 2 percent in the price of a security for which a public offering is being made" (Tr. 481).

[22] Each of the 49 entities had electric operating revenues of over $200 million in 1974 (Tr. 448).

profit rates on stockholder equity, Class A & B electric utilities have had generally lower variability over 1961 - 1975 than other industry groups examined, and for 1972 - 1975 the utilities group had lower profit values than the large majority of the other groups. This is part of the data he cites as indication that electric utilities are less risky than other industry groups and thus is a basis for his contention that they should expect to earn lower equity rates of return than unregulated firms.[23] This information is supplemented with earned equity rate of return values (over the second half of 1975 and first half of 1976) for 39 non-utility groups, which, when combined with utilities, produced an "all-industry" average value of 13.2% (Exhibit 98). (The composite utilities value alone was 11.2%.) He then concludes that an allowed equity rate of return for NEES of 11% - 12% should be adequate.

C. Staff Position

Staff's rate of return witness, Mr. Hutt, presented a comparable earnings analysis which concluded that a fair level of earnings on common equity for NEES during this locked-in period would be within a range of 12.75% and 13.25%.

Among other things, Mr. Hutt examines selected financial data which compares NEES with the major Class A and B electric utilities and nine electric holding companies for the five year period, 1971-1975 (Tr. 619, Exhibit 90). The selected financial data included information on earned return on average total capital, operating ratios, earned return on average common equity and average common equity ratios.

Mr. Hutt considered various factors which, in his judgment, increased or decreased the risk of investing in NEES' common

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[23] Additional testimony by Dr. Wilson gave Beta coefficient (Exhibit 104 and Tr. 455-456) and capacity utilization (Exhibit 105) calculations to further argue that utilities are relatively less risky.

equity.[24] However, he gives no indication as to how the various factors do in fact register quantitative impact. Mr. Hutt's final recommendation is a 13% return on common equity (Tr. 625).

D. Analysis Of Rate Of Return Evidence

Table 1, supra, summarizes the equity rate of return recommendations urged by the parties in this case. As indicated, these ultimate values embody market pressure and issue cost adjustments where the witness argued in favor of such. A rather significant range of values is shown, namely, 11.0 - 14.7%. (See fourth column of *Table 1*.) This contrasts with the narrower 11.0 - 13.8 range that characterizes the pre-adjustment rate of return values, as seen in the third column of *Table 1*. It is clear, therefore, that differences exist among the witnesses, not only in their pre-adjustment estimates, but also as regards what adjustment(s), if any, each witness contends should be made in order to obtain composite final values. We see a further narrowing of the pre-adjustment rate of return range when mid-point values are taken for the four witnesses who gave individual

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[24] At Tr. 624 Mr. Hutt states:

> I considered the following factors as being positive which would tend to reduce the rate of return.
>
> (1) NEPCO's protection under the umbrella of a large and well-established parent company; (2) reduced level of proposed construction expenditures; (3) reduced external financing requirements; (4) a decline in the cost of new capital in both the short-term and long-term market; (5) NEES' generally rising trend in its earned return on average common equity for the years 1971-1975 as contrasted with a generally declining trend for the nine electric holding companies and the major electric utilities as a group; (6) the declining trend in the dollar amount of average net utility plant per dollar revenues (capital turnover).
>
> Factors which tend to raise the rate of return are:
>
> (1) Increased uncertainty regarding future growth in sales due to energy conservation programs; (2) the erratic pattern of return earned on common equity; (3) NEPCO's lower earned return on average common equity relative to that for the major electric utility companies; (4) the comparatively high percentage of NEPCO's earnings accounted for by AFUDC.

ranges. Those calculations show the values 11.5 - 13.0 to span the tendered estimates, enabling one to conclude that collectively the seven witnesses have delineated some degree of concurrence about what should constitute the correct order-of-magnitude for the pre-adjustment rate of return values required by equity investors. [25]

We have found weaknesses and strengths in all of the witnesses' submissions. We shall not rely on any single one. But parts of certain presentations we find more useful than others, and we have drawn on such information in finding a return on common equity of 12.75% to be just and reasonable.

We find the DCF approaches presented in this particular proceeding were the most helpful. [26] In using a DCF framework here, we shall use the DCF form employed by most of the witnesses, namely, the simple "yield plus growth" representation.

Accordingly, we must quantify two components: (a) dividend yield; and (b) investors' expected growth rate. The result will give us the return that investors require on common equity. Then we must make a judgment as to whether any additional allowance or adjustment must be made to reflect market pressure and/or issuance costs and/or any other "cushions."

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[25] Mr. Hutt and Dr. Wilson, each using a comparable earnings approach, make no specific allowance for market pressure and other costs of issuing new common stock. Nor does either suggest any other allowance or cushion.

[26] Here the DCF approaches included a wide array of useful market growth oriented information such as various proxies for growth rate (e.g. dividends per share, earnings per share, tangible book value per share, and combinations of some of these), various time frames, DCF computations for NEES alone, a DCF computation for an 88-firm sample of the utility industry, etc. This does not mean that we have elevated DCF over other sound methods of determining allowed rate of return. We will use whatever presentations we find in a given case that, in our judgment, make the most sense and are the most helpful.

As to dividend yield, it is appropriate here to use a value representative of the locked-in period. Based on our review of the record, we find a dividend yield of 8.8% to be appropriate.

As to expected growth rate, we find that the record supports a growth rate range of 3.2% to 4.1% as most closely reflective of investor expectations for growth during the locked-in periods.[27] Within this range, our best judgment would place the growth rate factor in the middle to upper part of this range. This is so because, among other things, we feel that the strength of utility stocks during 1976 (which includes most of the locked-in period) indicates that investors had begun to increasingly discount the poor years of 1973-1975.[28] Further, Mr. Miller's ten year growth rate factor of 4.06% is probably closer to the mark (the expected growth rate) than his five year growth rate factor because it gives less weight to the very poor years for the utility industry of 1973-1975.[29]

As to selling costs (issuance costs and market pressure effects), we acknowledge the conceptual validity of such factors, and believe they would, as a general rule, have some, albeit minor, effect on the cost of obtaining common stock equity. In any event, we do not find in the record before us a definitive quantification of the magnitude of this effect. Most witnesses appear to have grossly overstated these costs, primarily because their values would apply to *all* common equity (existing as well as new issues) rather than being limited to new stock. The one witness who recognized this distinction subse-

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[27] This range, discussed above, includes: Mr. Miller's five year growth rate (1970-1975) of 3.20% and ten year growth rate (1965-1975) of 4.06%; Mr. Rose's five, ten and twenty year growth rates (each including up to the first eleven months of 1976) of 3.78%, 3.95%, and 3.81% respectively and Mr. Noyes' twenty year growth rate (1956-1975) of 4.1% (Tr. 422).

[28] See also testimony of Mr. Miller at Tr. 472.

[29] Mr. Rose states that in 1974 utility common stocks hit a low in investor confidence unmatched since the early 1930's (Tr. 358).

quently deduced a very small increment. While we do not accept his numerical value *per se*, we do find merit in the reasoning that suggests only a minor increment is involved. Indeed, it appears that the magnitude in this case is so small as to be within the range of error associated with estimating the cost of common stock equity. Therefore, such minor amount of selling costs that may be assignable to cost of service in this case can best be incorporated in the overall estimate of the appropriate rate of return allowance for common stock equity.

Our DCF approach here results in adding the dividend yield of 8.8% to the growth rate range of 3.2% - 4.1%. Thus, we get a range of 12.0% to 12.9%. We feel that the comparative earnings studies and the risk premium analyses in the record corroborate our finding.

A rate of return for a utility must be commensurate with returns on investments in other enterprises having corresponding risks and should be sufficient to assure confidence in the financial integrity of the enterprises so as to maintain its credit and to attract capital.[30] In attempting to achieve these objectives, we have carefully reviewed the testimony of each of the parties together with their supporting evidence. On the basis of our analysis, we find a rate of return on common equity of 12.75% to be our best judgment as to the cost of common equity to NEES during the locked-in period considered.

As indicated earlier, *supra* pp. 3-6, the cost of common equity determined by reference to NEES, as proxy, is reasonably applicable to the whole of NEP's operations, including its investment in the Yankee generating companies. We must now consider what adjustment must be made to this value so as to reflect the higher risks borne by the NEP operating company (the subject of this proceeding) as a result of the cost-of-service

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[30] *F.P.C.* v. *Hope Natural Gas Company*, 320 U.S. 591 (1944), and *Bluefield Waterworks* v. *P.S.C.*, 262 U.S. 679 (1923).

tariffs. We begin by noting that NEP should be permitted a 12.75 percent rate of return on the sum of its common equity, consisting of $254.8 million in its wholly-owned facilities and $34.2 million in the Yankee generating companies.[31] With respect to the Yankee investments, the most recent determination on rate of return involved the Yankee Atomic Electric Company where the Commission accepted a settlement rate of return on common equity of 10 percent.[32] We have also reviewed the cost-of-service rate schedules of the other Yankee companies that were in effect during the locked-in period of this case as well as their earned rates of return on common equity during 1976.[33] Based on this information we believe it reason-

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[31] See the discussion, *infra* pp. 24-26, especially footnote 35. NEP's equity investment and percent ownership in each of the Yankee generating companies is as follows:

Connecticut Yankee	$5.7 million (15%)
Maine Yankee	13.4 million (20%)
Vermont Yankee	10.5 million (20%)
Yankee Atomic	4.6 million (30%)

[32] *Yankee Atomic Electric Company and Public Service Company of New Hampshire*, Docket Nos. E-9420 and E-9421, Order Approving Settlement Agreement and Reversing Initial Decision on Rate of Depreciation, issued July 20, 1977.

[33] The rate schedules of Vermont Yankee and Maine Yankee specify rates of return on common equity of 10 percent and 9.8 percent, respectively. The Connecticut Yankee rate schedule initially specified an overall rate of return of 6.0 percent which produced less than 10 percent on common equity. The filing in Docket No. ER76-360, however, raised this to an overall rate of return of 10 percent effective November 5, 1978.

This is corroborated by the U.S. Department of Energy's *Statistics of Privately Owned Electric Utilities in the United States 1976* where, in Section IX (Selected Financial Ratios) the following earned rates of return on common equity are shown:

Connecticut Yankee	6.0%
Maine Yankee	10.1%
Vermont Yankee	9.9%
Yankee Atomic	10.4%

able to assume that NEP can expect an average of 10 percent on the $34.2 million it has invested in the Yankee companies. The problem thus becomes one of determining the return we should permit NEP to earn on its wholly-owned $254.8 million so that it will be offered the opportunity to realize 12.75 percent on the whole of its common equity capital, $289.0 million. We find this rate of return to be 13.12 percent. [34]

E. Capital Structure Issues

Three issues relating to capital structure were decided by the Judge: (1) *Cost of Long Term Debt* (ID at 13-14); (2) *NEP Equity Investment in Yankee Generating Subsidiaries* (ID at 14-16); and (3) *Source of NEP Equity* (ID at 16-17). We affirm and adopt the Judge's decision on the first issue. As to the second and third issues, we modify the Judge's decision as discussed below.

NEP INVESTMENT IN YANKEE GENERATING COMPANIES

The issue is whether some adjustment should be made to NEP's capital structure to reflect its investment in the joint Yankee nuclear ventures. The initial decision concluded that NEP funded its investment in the joint projects through the issuance of both preferred and common stocks. Based on the information on NEP's external financing from 1955 to 1972 (Exhibit 73), the Judge determined that 62 percent of the $38.7 million Yankee investment should be deducted from NEP's common equity and 38 percent from preferred.

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[34] This is obtained by subtracting the return realizable from the Yankee investments (.10 x $34.2 million) from the return NEP should be permitted to realize on all investments (.1275 x $289.0 million) and solving for the rate of return that must be allowed on the operating company common equity of $254.8 million. Alternatively, (.10)(34.2) + r($254.8) = (.1275) ($289.0), and r = .1312 or 13.12 percent.

NEP opposes the initial decision and requests that no adjustment be made to its capital structure except for the deduction of undistributed equity earnings from common equity as required by the Commission's Order No. 469.[35] NEP argues that its method does not yield an unjust and unreasonable result given its actual earnings on the Yankee investments. While the Judge rejected this argument saying it would permit NEP to make up in this proceeding for an alleged shortfall in another, NEP claims that the instant proceeding is the proper one to permit it to recoup its capital costs. NEP argues that the capital costs incurred in providing the services being priced in this proceeding include the cost of the capital invested in the nuclear companies as well as the capital invested in its rate base. It claims that the actual return earned on the Yankee investments is well below NEP's composite cost of capital and that only if NEP's return on these investments exceeded its composite cost of capital would NEP's method produce an unjust and unreasonable result.

NEP asks the Commission to reconsider its Opinion Nos. 803 and 803-A where the exclusion of NEP's Yankee investment was made solely from common equity. NEP argues that it is only a part owner of the various Yankee companies and thus NEP cannot force the other owners to raise their rates to enable NEP to obtain an adequate earnings level. NEP further notes that raising the Yankee companies' rates would mean higher taxes for these companies which would, in turn, impose higher costs upon consumers.

MRC also excepts to the initial decision saying the deduction of the full $38.7 million should be from common equity. It cites Commission Opinion Nos. 803 and 803-A for support.

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[35] Pursuant to Commission Order No. 469 issued February 1, 1973, NEP deducted $4.5 million from its common equity, representing NEP's interest in subsidiary undistributed earnings. Witness Miller proposes the additional deduction of approximately $34.2 million, representing NEP's interest in Yankee generating subsidiaries common equity.

NEP's method is rejected. To accept its approach would, by direct implication, mean that the full amount of the Yankee investment was financed by a combination of debt, preferred stock and common equity in the same proportions that NEP financed its own rate base. If this were the case, we would have to adjust the capital structures of the Yankee companies to reflect this financing arrangement. Otherwise, the rates established for these Yankee companies would yield returns to their owners in excess of the costs of financing them. This would be a difficult task given the number of participants in these projects. However, our failure to make such adjustments would result in return and tax components of the Yankee costs of service that would be excessive.

The method employed in the initial decision, deducting the amount in question pro rata from common and preferred stock pursuant to Exhibit 73, is also troublesome. It, too, imposes upon the Commission the responsibility to reflect this financing in setting rates for the Yankee companies. We are reluctant to embark on that path. In the case of jointly-owned projects like the Yankee generating companies, investments by the owner-partners should be from common equity capital only. The jointly-owned company should obtain the prudent amounts of debt and preferred stock capital directly from the marketplace. We find NEP's claimed financing scheme (Exhibit 73), that employed in the initial decision, to be improper and unreasonable for use in setting the proper return and tax components of NEP's cost of service.

We find no merit in NEP's arguments that it should be allowed to recoup alleged shortfalls in earnings from the Yankee investments in this proceeding. This problem, to the extent that it relates to the lower returns allowed Yankee companies due to the transfer of risk via the cost-of-service tariffs, is discussed and resolved above in our determination of the rate of return on common equity for this proceeding. As a general

principle, the rate of return allowed on NEP's rate base should be based on the cost of the capital devoted to that investment commensurate with the attending risks. Likewise, the allowed return on the Yankee company rate bases should be based on their capital costs commensurate with their risks. We cannot and do not make a determination in this proceeding that the risks and allowed rates of return on common equity should be the same for all of NEP's investments. NEP's arguments are based on the premise that it is. We note that in Docket Nos. E-9420 and E-9421, we agreed to a settlement proposal on the rate of return on common equity of Yankee Atomic Electric Company of 10.00%, well below that permitted in this proceeding.[36] The capital structure accepted in that docket consisted of 55.3% debt and 44.7% common equity.

In short, we find no reason to depart from the approach followed in our Opinion Nos. 803 and 803-A. The full Yankee investment of $38.7 million should be deducted from the common equity component of NEP's capital structure.

NEES DEBENTURES

The initial decision rejects MRC's recommendation to reflect, in the return and tax allowances, an alleged double leveraging by NEES in its subsidiary financing. While noting that it is often necessary and appropriate to pierce the corporate veil to reach a just and equitable result, the Judge found that the limited record evidence concerning the source of funds invested in NEP equity and the conflicting testimony on the use by NEES of the debenture-derived funds provided insufficient support of MRC's proposed adjustments.

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[36] See *Yankee Atomic Electric Company and Public Service Company of New Hampshire*, Docket Nos. E-9420 and E-9421, Order Approving Settlement Agreement And Reversing Initial Decision On Rate Of Depreciation, issued July 20, 1977.

MRC excepts to the Judge's determination arguing that he failed to adequately review the record on this issue. MRC contends that there was a full discussion of this issue by both its witness Miller and NEP's witness Rose and that the evidence supports its proposed adjustment.

We disagree with the Judge that there is insufficient record evidence upon which to evaluate MRC's proposed adjustment. However, we reject MRC's proposal that we adjust NEP's capital structure to reflect NEES' debt. As we said in Opinion No. 7 [37], we believe that the preferred regulatory approach is to utilize the subsidiary's capital structure where it would produce a reasonable end result. NEP's capital structure, without MRC's proposed adjustment, is not atypical. NEP's overall rate of return is fair and consistent with the tests of the *Hope* and *Bluefield* cases. Moreover, were we to allocate, consolidate or otherwise consider NEES' debt holdings, logic would also require allocation or other consideration of NEES' holding company expenses. The record is inadequate on this latter point. However, even if an adjustment could be made properly to account for the NEES' holding company expenses, nevertheless the net effect of the adjustment to NEP's capitalization as recommended by MRC and the additional cost of service adjustment to reflect the NEES' holding company expenses would not be substantial. It is concluded that MRC's proposal has not been shown to be reasonable or necessary on the present record.

F. Capitalization Table

Employing NEP's actual capital structure as of December 31, 1976 adjusted to reflect our determinations on deferred

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[37] *Kentucky West Virginia Gas Company*, RP73-97, issued February 16, 1978.

taxes,[38] the Yankee investments, the NEES debentures, and the $50 million bond issue, we find the just and reasonable overall rate of return for NEP is 9.20%:

	Amount (000)	Percent	Cost Rates	Component Weights
Long Term Debt	$435,000	54.32	7.34	3.99
Preferred Stock	111,028	13.86	7.51	1.04
Common Equity	254,806	31.82	13.12	4.17
	$800,834			9.20

IV Salem Harbor #5 Project

A. Background

The issue here involves what ratemaking treatment should be afforded NEP's investment in the now cancelled project to install an additional 880 megawatt oil-fired electric generating unit at its Salem Harbor generating station. No party to this proceeding contends that NEP's investment in Salem Harbor #5 was imprudent.[39] Nor does any party challenge the reasonableness of the costs incurred. As of the date of cancellation of the project in November 1975, NEP had incurred expenses of approximately $13,150,000 (Tr. 1643).[40] NEP wrote off this

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[38] In *Minnesota Power and Light Company*, the Commission found that deferred taxes (Account No. 281) should be deducted from rate base and not included as a component of capital structure at zero cost. Docket No. E-8494, Opinion No. 12, issued April 14, 1978.

[39] NEP's evidence as to the prudency of its decisions regarding Salem Harbor #5 appear in the testimony of Mr. George P. Sasdi, the Project Manager for the Salem Harbor #5 project (Tr. 429-455, 1302-1362, Ex. No. 88 and Mr. Robert O. Bigelow, NEP's Director of Planning and Power Supply (Tr. 1877-1914, Ex. No. 142). The most salient factors mentioned were the effect on oil prices resulting from the OPEC oil embargo and reduced load growth forecasts.

[40] Subsequently revised to $12.9 million following negotiations with vendors on cancellation charges for ordered equipment.

entire loss on Salem Harbor #5 on its 1975 federal income tax return. NEP thereby had a tax reduction of approximately $6,127,000 to offset the loss, which resulted in a net loss to NEP of approximately $7,023,000 (Tr. 643). To recover its loss NEP proposes to amortize the Salem Harbor #5 costs over a 5 year period and to include in its rate base the unamortized portion of those costs. All parties oppose NEP's proposal to give rate base treatment to these costs. All parties accept NEP's 5 year amortization proposal except RI which advocates a 10 year period. [41]

Other questions which relate to how the Salem Harbor #5 costs should be dealt with here for ratemaking purposes include: (1) whether NEP should be allowed to recover only the net loss (or after-tax amount) of the Salem Harbor #5 costs, and (2) what is the propriety of charging NEP's customers with 100% of the loss, when the facts are that only 75% of Salem Harbor #5 was needed for NEP's requirements with the remaining 25% to be sold to other utilities. (Tr. 1888-1891) Staff advocates that NEP be allowed to write off as an expense for ratemaking purposes one fifth (1/5) of 75% of the net loss per year for 5 years. MRC and MASS support Staff's position. RI, as noted above, advocates use of a 10 year amortization of 100% of the gross loss. NEP requests 100% of the gross loss (approximately $13 million) amortized over a 5 year period.

The Judge's decision rejected NEP's proposal to include the unamortized balance of the Salem Harbor #5 costs in the rate base and concluded that NEP should be permitted to amortize 100% of its net (after-tax) loss (approximately $7 million) over a 10 year period.

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[41] RI's witness, Mr. Hartikka, stated that use of a longer amortization period would have the effect of having NEP security holders shoulder more of the Salem Harbor costs. (Tr. 600) Mr. Hartikka felt a ten year amortization period and exclusion of unamortized costs from rate base was a fair solution to the problem of how to equitably apportion the risk between ratepayers and investors. (Tr. 600)

B. Rate Base Treatment

The Judge summarized the situation as follows:

> It is not disputed that NEP should be entitled to recoup its Salem Harbor expenditure. This undertaking was deemed a prudent investment to finance essential plant expansion at the time that this investment was made. However, all parties, including NEP, acknowledge that there is no precedent for affording rate base treatment for this type of cost.
>
> NEP argues that this matter is unique and a new precedent should be established. Thus, NEP contends that ratepayers should be required to pay a return on a $13 million expenditure related to an aborted project which NEP has already written off for income tax purposes at a net cost of only some $7 million.
>
> There is no precedent, or reasonable justification in the record of this proceeding, to require ratepayers to pay a return on an expenditure that has not resulted in productive plant that is used or useful in the public service.
>
> Ratepayers are not required to insure that a utility receive a return on all monies invested in the enterprise; ratepayers are required to pay a return on only those investments in properties that are used and useful in the public service.
>
> The argument that the security holders should be fully insulated from all risk in this matter is rejected. While a regulated utility may have a lesser degree of risk than unregulated companies that must compete for their markets, this is not to say that it is in the public interest to shield utility security holders from all risks, including the risk that management may initiate projects that do not become productive. This is a risk of any business.
>
> While it is clear that inventors in utilities would prefer to have ratepayers absorb losses resulting from aborted projects, such preference does not constitute justification for casting the entire burden of such losses upon ratepayers.

> NEP's proposal to afford rate base treatment for the unrecovered portion of this expenditure is rejected. (ID at 21-22)

We agree with the Judge's decision and rationale in denying rate base treatmemt. NEP is the only party that excepts to the Judge's decision on this point. NEP raises no arguments which would warrant any modification of the ID on this issue.

C. Cost Of Service Treatment

This issue has three separate components as discussed above — (1) what amortization period to use; (2) whether to allow NEP to amortize its net (after-tax) loss or its gross loss; and (3) whether to allow NEP to amortize 75% or 100% of its loss.

First, as to the amortization period to use, the Judge decided that the amortization period should be 10 years. The Judge found, among other things that it is a basic principle that amortization period should be related to the economic life of the property and that this principle applies to the Salem Harbor #5 expenditure in issue; the Judge stated:

> While this expenditure did not result in productive plant, the expected life of this plant, if it had been completed, is a factor to be considered.
>
> * * *
>
> As noted, no party supports use of an amortization period having a length in line with the expected useful life of a generating plant. However, use of a period of 10 years for this purpose is more reasonably reflective of the expected life of the Salem Harbor plant expansion, than the proposed five year period, if this plant had been completed. (ID at 24)

We modify the Judge's decison here so NEP can use a 5 year amortization period. While this is a close question which in-

volves delicately balancing the interests of investors and ratepayers, we find that NEP's 5 year amortization period is reasonable. All parties except RI, as noted above, accepted NEP's 5 year proposal as reasonable. Even RI, which put forth the 10 year amortization period, states that "[t]he choice of a proper amortization period inevitably will be an arbitrary one." [42] Staff points out that spreading out 100% of a $7 million net loss over a 5 year period for more than 30 resale distribution customers as well as several industrial customers represents less than 0.5% of the total cost of service. [43] NEP argues, *inter alia*, that the 5 year amortization period has not been shown to be unreasonable, that its impact on NEP's cost of service is minor and, that a 5 year amortization period, as opposed to one of 10 years, places most of the burden on the same customers whose increased demand during the early 1970's made Salem Harbor #5 a prudent investment. [44] NEP further contends that the hypothetical plant life factor used by the Judge is irrelevant. [45]

On balance, we find that the 5 year amortization period is reasonable and that the impact of this cost of service component on the ratepayers will not impose an undue burden.

Second, as to whether to allow NEP to amortize its net (after-tax) loss or its gross loss, we reverse the Judge and permit NEP to amortize its gross loss for the Salem Harbor costs. The impact of this decision will be to allow NEP to collect (after taxes) the $7,063,000 of after-tax loss that it incurred. If NEP is not permitted to write off the gross loss of approximately $13 million, it will not receive full recovery of the expenditures.

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[42] RI's Brief Opposing Exceptions at 4.

[43] Staff's Brief On Exceptions at 12.

[44] NEP's Brief On Exceptions at 22-25.

[45] *Id.*

The Judge, however, concluded that the issue is the extent to which security holders should be protected from risks. In his words:

> The argument that the security holders should be fully insulated from all risk in this matter is rejected. While a regulated utility may have a lesser degree of risk than unregulated companies that must compete for their markets, this is not to say that it is in the public interest to shield utility holders from all risks, including the risk that management may initiate projects that do not become productive. This is a risk of any business.
>
> While it is clear that investors in utilities would prefer to have ratepayers absorb losses resulting from aborted projects, such preference does not constitute justification for casting the entire burden of such losses upon ratepayers. (Id. at 21-22).

It is evident that unless security holders are shielded against risk of losses resulting from aborted projects by way of inclusion in cost of service, the cost of capital will be higher to an extent necessary to compensate for the additional risk. Thus, if rate of return is required to be sufficiently high to enable the public utility to attract capital, the risk of such losses must be borne by ratepayers either directly (through cost of service) or indirectly (through rate of return). Of course if there were reason to believe that shareholders in NEP or in electric utilities in general, are bidding down the prices of securities and thereby bidding up the cost of capital in the expectation that such losses will be assessed against stockholders rather than ratepayers, an argument could be made that allowance of the loss would result in double counting. But there is no reason to believe that this is occurring and indeed no evidence of such occurrence in this record.

Third, as to whether to allow NEP to amortize 75% or 100% of its loss, the Judge found that NEP should be allowed to amortize 100% of its loss. The Judge reasoned that NEP's

expenditures were of a preliminary nature and that therefore the approximately $13 million expenditure was necessary whether NEP built a 660 megawatt unit or a 880 megawatt unit. As noted above, 75% of the 880 megawatt unit was needed for NEP's requirements with the remaining 25% to be sold to other utilities.

Staff, MRC, and MASS have urged that NEP should be allowed to flow through only 75% of the loss.[46] Staff contends that even if Salem Harbor #5 had been completed as planned, with only 75% of the unit "used and useful" for service to NEP's customers, then only 75% of the Salem Harbor #5 investment would be reflected in NEP's rate base and cost of service.

We find this to be an extremely close question since NEP customers are being asked to bear 100% of this expenditure even though only 75% of the unit was planned to serve them (Tr. 1890). However, we decide to allow NEP to amortize its full loss since the record reflects that the Salem Harbor #5 preliminary expenditure of roughly $13 million would have been no less even if NEP were planning to construct only a 660 megawatt unit.

On balance we find that, in viewing all the segments of the Salem Harbor #5 issue, we have struck an equitable balance between the interests of investors and ratepayers.

V Narragansett Generating Credit

In 1967, NEP and NARR entered into an integrated facilities arrangement which provided for the integration of NARR's generating facilities with NEP. Under this arrangement NEP charges NARR for power sales, but NEP credits NARR on NARR's purchased power bill, for all costs associated with the

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[46] Only Staff specifically and vigorously excepts to the Judge's decision on this point.

use of NARR's generating facilities. Prior to 1967, NARR operated its generating facilities primarily as part of its intrastate business. NARR flowed through to the intrastate customers the tax benefits which resulted from accelerated depreciation on its generating facilities. Subsequent to 1967, the cross-over point [47] was reached where the annual book depreciation on the generating facilities exceeded the income tax guideline depreciation, thereby creating an increase in taxable income. NARR sought to pass on the increased taxes, once the cross-over point arrived, to NARR's intrastate customers notwithstanding the fact that the facilities at issue were then a functional part of NEP's integrated system. [48] However, the Rhode Island Public Utilities Commission (RIPUC) was upheld by the Rhode Island Supreme Court in turning down NARR's attempt to pass on the increased taxes to its intrastate customers. The Rhode Island Supreme Court stated as follows:

> The gravamen of [NARR's] objection to this portion of the report and order is that, although the production facilities in Providence are interstate in character, its intrastate customers have, in past years, benefited by a flow through of construction tax benefits and the usual excess of guideline over book depreciation.
>
> [NARR] maintains that it would be inequitable at this point to shift the burden of tax liabilities to its only interstate customer, [NEP], when that entity has never been the beneficiary of [NARR's] past favorable tax status.
>
> * * *
>
> [U]nless NARR shows that the [RIPUC] abused its discretion, we cannot fault the [RIPUC's] chosen method of allocating the excess of book over guideline depreciation strictly on the basis of the percentage of that figure

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[47] NEP witness Brown, at Tr. 996, testifies that this cross-over point occurred in the early 1970's.

[48] *See* Tr. 1004-1005 and NEP's Initial Brief at 47.

> attributable to interstate power generating facilities. [NARR's] attempt to invoke the aid of equity to alleviate the burden that this allocation of tax liabilities precipitates upon its sole interstate customer in no way undermines the presumed reasonableness that the [RIPUC's] decision on this point enjoys. The [RIPUC] reached its result on the basis of undisputed legal evidence both as to dollar amounts and as to inter/intrastate ratios.[49]

Since NARR was turned down by the Rhode Island Supreme Court, NEP now seeks recognition of the increased tax expense from the FERC. The Judge in our proceeding summarized the positions of the parties[50] as follows:

> Staff contends that since retail customers located in Rhode Island have received the benefits of lower rates as a result of the flow through of tax benefits in prior years, there is no justification for including a higher tax expense arising from the current excess of book depreciation over tax guideline depreciation in determining a fair level of rates for NEP's wholesale customers in this proceeding.
>
> NEP points out that in 1975, the Rhode Island Utilities Commission disallowed the full assessment of this tax expense against RI's retail customers and allocated this expense among retail and wholesale customers. Therefore, in this proceeding, NEP seeks to recoup the appropriate portion of this expense allocated to its wholesale customers. (ID at 25)

The Judge then adopted NEP's approach stating as follows:

> The Rhode Island Commission allocated the additional tax expense in issue to intrastate service based on the portion of plant used for such service. The Rhode Island court held that this method is a reasonably equitable manner of handling this matter.

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[49] *Narragansett Electric Company* v. *Harsch, et al.*, 368 A.2d 1194 at 1205-1206 (1977).

[50] MRC supports Staff's proposal to reduce NEP's claimed federal taxable income for the NARR generating credit by $1,239,000. RI supports NEP's approach (Tr. 595-A to 599).

> It is concluded that it is impractical and unrealistic to seek to use rates as a vehicle to make retroactive adjustments to recoup or to offset rate reductions of the past arising from flow through of tax deferral benefits.
>
> There is no assurance that the customers who received benefits in the past would be the same customers who would be called upon to pay higher rates in future periods because of such past benefits.
>
> The most equitable method of handling this matter is to allocate the additional tax expense in issue based on the portion of plant that is currently used to serve interstate customers.

We reverse the Judge on this issue and accept Staff's proposal to reduce by $1,239,000 the federal taxable income used by NEP to calculate the NARR generating credit (Tr. 642-643).[51] Our decision is based on equitable considerations. Since 1967, NEP, in developing the NARR generating credit, has been normalizing the tax effect of the difference between guideline and book depreciation. Under normalization, NEP's interstate wholesale customers have not been the beneficiaries of the additional tax deduction when guideline depreciation exceeded book depreciation. Therefore, it is inappropriate for the interstate wholesale customers to now be burdened with the additional expense when book depreciation exceeds guideline depreciation. The RIPUC's decision will not cause us to shift this tax burden to the interstate wholesale customers where it does not belong.

Finally, we further find that the 12.75% rate of return on common equity applies to NARR as well as NEP, NEES being the proxy for each, and that an overall return of 8.86% (for NARR) is appropriate for purposes of calculating the "G&T" credit. (See Exhibit No. 111 Schedule 4 which should be

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[51] The $1,239,000 represents the excess of book depreciation over income tax guideline depreciation.

adjusted to reflect a 12.75% rate of return on a common equity ratio of 33.70)

VI Rate Design Issues

A. Franchise Tax Surcharge

The Judge stated the issue and his reasoning as follows:

> NEP pays various forms of taxes in the states in which it operates, including franchise taxes. RI advocates allocating the franchise taxes to NEP customers in the states that levy such tax, in the form of a surcharge to be charged against ratepayers. NEP now rolls-in all tax costs as an expense to be borne by all customers served by NEP.
>
> * * *
>
> The current NEP method of rolling-in all taxes, local, state and federal, has a long historic precedent. Deviation from this established procedure should not be permitted in the absence of unusual or compelling circumstances which would call for allocation of tax expense in order to insure equity.
>
> There is no showing in this record that the franchise taxes paid by NEP meet the criteria of unusual or compelling circumstances. In light of the foregoing, RI's proposal to allocate franchise taxes by taxing jurisdiction is rejected. (ID at 27-28)

No exceptions were taken. We affirm and adopt the Judge's decision on this issue.

B. Subtransmission Rates and Transformer Discount

NEP uses a "standard delivery point" (SDP) concept [52] as a measuring point for setting rates for its wholesale customers. [53]

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[52] See Appendix A.

[53] NEP witness McDade explained NEP's three-part rate structure based on the SDP concept as follows:

> Q. Please state specifically the relationship of the concept of the power

The effect of NEP's rate design is to divide its customers into three classes[54]: (1) the high voltage (HV) customers who take delivery at high voltage directly from a line in the power supply system and who supply their own step-down transformation; (2) the standard delivery point (SDP) customers who take delivery at or adjacent to the low voltage terminals of NEP's step-down transformers; and (3) the beyond SDP customers who receive service at points beyond NEP's low voltage terminals. To serve these beyond SDP customers NEP uses the subtransmission facilities (so called "red book" facilities) of its affiliate Massachusetts Electric Company (or Mass Elec).

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supply system and standard delivery point to subtransmission costs.

A. As I testified in response to an earlier question, the components of the power supply system, consisting of the production plants, transmission lines tying the production plant to one another and to transmission interconnections with other major power sources, transformation and associated equipment to provide one step-down from the power supply line voltage, represent costs which are common to all primary resale customers. The low side of the transformer off the power supply line is the standard delivery point and is the point at which the commonality of costs among the primary resale customers ends. It is for this reason that costs up to the standard delivery point should be shared and costs after the standard delivery point should be borne by the customers receiving the service.

Q. What is the rationale for including costs of transformers and associated equipment for providing one step-down from the power supply line voltage as part of the costs common to all primary resale customers?

A. The step-down service is provided for a major portion of the primary resale customers and those who do not receive the step-down service [the high voltage (HV) customers] receive an adjustment in their rates because they have supplied their own transformation. When deliveries and metering are at points other than the standard delivery point, the charges are adjusted to that point by means of credits and additions in billing. This is the only way that all customers can be treated on an equal basis. (Tr. 279)

[54] Tr. 278-279.

MRC, on the other hand, advocates a two-part rate structure with the SDP customers and the beyond SDP customers constituting a single class of customers. This proposal would have the effect of charging the same rates to all customers who receive power at or below 69,000 volts, whether they use the red book facilities or they do not. The Judge assessed the impact of MRC's proposal on the SDP customers and the beyond SDP customers as follows:

> MRC would eliminate the SDP, which would reduce the charges to customers who take power beyond the SDP point, at voltages below 69,000 volts. The approach advocated by MRC would shift about $1 million in costs now assessed in large part against the MRC group and levy such costs against an affiliated company, Mass Electric. This company serves customers located in Massachusetts. Thus, the effect of the MRC proposal is to shift a substantial portion of subtransmission costs to Mass Electric customers.
>
> NEP points out that subtransmission costs are initially allocated between NEP and Mass Electric, and that application of the MRC approach would result in a second and additional allocation of costs against Mass Electric customers. NEP, Mass, RI and Staff oppose such second allocation as unreasonable and unsupportable. (ID at 29-30)

We agree with the Judge's decision and rationale in adopting NEP's three-part rate structure. [55] The fact that the beyond SDP

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[55] In rejecting MRC's two-part rate structure, the Judge found the MRC witness's study to be unreliable. The Judge stated as follows:

> A number of arbitrary assumptions and subjective evaluations were included in this study concerning the segments of plant and related costs required to provide low voltage service. No precedent could be cited for the methods used in this study. Further, a number of factual errors and assumptions that were at material variance with the facts relating to NEP's electric system, were disclosed upon evaluation of this study.
>
> It is concluded that the study presented by MRC does not provide the probative evidentiary record required to justify alteration of the rate design method used by NEP in this proceeding. (Id. at 30-31)

customers have to bear the burden of the Mass Elec subtransmission (or red book) costs [56] is reasonable and non discriminatory since these facilities are used and useful *only* to the beyond SDP customers. Thus, the evidence clearly supports the conclusion that these subtransmission costs of NEP's system are isolated for cost allocation purposes.

The Effect Of The R-9 Settlement On The Subtransmission Rates

Now we come to our only point of departure from the Judge's initial decision on the subject of "Subtransmission Rates and Transformer Discount" (Id. at 28-31). Our departure relates to a problem of interpretation arising from the R-9 Settlement Agreement. The Judge summarized the situation as follows:

> It appears that this rate design dispute has resulted, in part, from varying interpretations of the R-9 Settlement Agreement, in which it was stipulated that the former monthly surcharge of [46¢] per kilowatt for subtransmission service would be reduced to 5¢.
>
> NEP contends that by agreeing to this reduced surcharge, it did not agree to forego recovery of the full amount of the lease costs it has incurred as the result of use of Mass Electric facilities. Thus, NEP's proposed revised rates are designed to charge the deficiency between this cost and the proceeds from the 5¢ surcharge, against all NEP customers, whereas MRC would charge this deficiency against only subtransmission customers. This MRC proposal would have the effect of a second or an additional charge against Mass Electric customers. (Id. at 30)

The Judge agreed with NEP's proposal. [57] MRC and Staff strongly excepted to the Judge's decision on this point. Both

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[56] The Mass Elec subtransmission cost, as reflected by Exhibit 16, is $1,025,000.

[57] Id. at 30.

MRC and Staff have argued before the Judge that NEP had agreed to a charge of 5¢ per kw of demand for subtransmission service. Staff further argues (Brief On Exceptions at 14-15) that if there are any "excess" costs specifically related to the subtransmission facilities, ratemaking procedures should not allow such "excess costs" to be borne by customers who do not receive any benefit from such facilities. MRC further argues (Brief On Exceptions at 10) that NEP must assert one of two propositions — either the Mass Elec subtransmission costs are properly assessed against all customers as part of the cost of service to all classes of customers, or the subtransmission costs are used only to serve the beyond SDP customers as a separate group, properly differentiated from all other classes of customers. MRC states that if NEP asserts the second proposition, then NEP cannot argue that any "shortfall" in revenue, attributable to the beyond SDP customers for subtransmission service, should be added to the basic cost of service for all customers (Id. at 10).

We reverse the Judge on this point. We find the R-9 settlement agreement[58] clear on this matter — NEP agreed that it

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[58] See Article II of the settlement agreement (Docket Nos. E-9136 and E-9140) approved by the FPC on July 12, 1976, which reads as follows:

Supplemental Charge

2.1 In its Rate R-10 filing of November 28, 1975, NEP tendered tariff sheets which sought to raise the charge for service in connection with delivery at other than Standard Delivery Point from 5¢ per kw of demand to 46¢ per kw of demand. Said increased charge is due to become effective as of March 1, 1976. The Company agrees to file a revised tariff sheet which reduces this charge from 46¢ per kw of demand to 5¢ per kw of demand and to request an effective date of March 1, 1976, for such reduction.

2.2 The Company further agrees that it will not increase this charge prior to January 1, 1977. It is understood and agreed that the Company may submit for filing a proposed increase in such charge and may request a proposed effective date prior to January 1, 1977, provided that the company requests suspension of the increase until January 1, 1977.

would not increase the 5¢ charge to 46¢ prior to January 1, 1977. Further, there is no evidence that the HV or SDP customers agreed to share the burden of the red book costs incurred by serving the beyond SDP customers. Thus, the charge must remain at 5¢ for the entire locked-in period here except for the month of January, 1977. For January, 1977 a charge of 46¢ assigned only against the beyond SDP customers is proper and consistent with our discussion above with regard to who should bear the red book costs.

The Transformer Discount

Pursuant to NEP's three-part rate structure, recognition is given via a transformer discount to the HV customers since these customers provide their own step-down transformation at high voltage. [59] The transformer discount reflects the cost saving to NEP.

RI objects to the NEP study which resulted in a reduction of the transformer discount for HV customers from 30¢ to 15¢ per kilowatt per month. RI contends that NEP should have utilized cost data relating to NEP's high voltage transformers rather than using, as a proxy, cost data relating to NARR's high voltage transformers.

2.3 No moratorium whatsoever is here intended in regard to the Company's rates other than its charge for delivery at other Standard Delivery Point.

We note that Docket No. E-9140 relates to NEP's R-9 rate increase and that the settlement agreement there resulted from discussions between NEP, MRC and representatives of the Rhode Island Attorney General's Office, the Rhode Island Consumers' Council, the Rhode Island Public Utilities Commission and the Staff of the Federal Power Commission held at various times.

[59] The record at Tr. 2263-2264 reflects that of the percentage of NEP's sales subject to the 15¢ transformer discount, 75% go to NARR.

The Judge found as follows:

> RI has not demonstrated that the use of NARR data for the derivation of NEP transformer costs is unrepresentative of such costs. It may have been preferable to use NEP costs for this purpose, but there is no showing that the cost of operating transformers varies materially between these two corporate affiliates. It could be concluded that a 15¢ discount per kilowatt per month may be too high in light of the NEP study which supports the 12.8¢ discount. However, a 15¢ discount will be utilized in this proceeding as reasonably representative of this cost factor, and NEP will be expected to update the costs supporting such discount in any future rate proceeding. (Id. at 31)

We agree with the Judge's assessment here and find no argument raised on exception which would warrant any modification of the Judge's initial decision. [60]

C. Contract Demand (CD) Rate

We agree with the contract demand (CD) rate calculations approved by the Judge (Id. at 31-33) with the exception of the Judge's treatment of the impact of the R-9 settlement agreement on the subtransmission costs. The CD rate calculations must be recalculated to be consistent with our decision on this matter discussed *supra*.

One further issue regarding the CD rate calculations merits discussion — what method should be used to develop the CD

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[60] The Judge's assessment that a 15¢ discount may be too high in light of the NEP study reflecting a 12.8¢ discount is explained by the following:

> Due to an error in copying the kilowatts associated with the Drum Rock substation, Mr. McDade's original result was 15 cents. His correction (Tr. 2336-2337) raises the kW in his denominator from 4,242,000 kW to 4,978,000 kW (Exhibit No. 18, p. 1). Performing the division of the corrected denominator results in a credit of *12.8 cents* ($639,409 ÷ 4,978,000 kW). (NEP's Initial Brief at 53 (footnote 3)).

customers' demand requirements. The Judge stated the issue as follows:

> Staff also proposes use of the December coincidental peak power use by CD customers in lieu of NEP's use of a projection of the first 10 months of 1976 to develop CD customers demand requirements.
>
> NEP acknowledges that the approach it used in its CD rate calculations is different from the approach used to derive total system demands. However, NEP emphasizes that CD power use during the first 10 months of the year is higher than December use. Thus, NEP argues that its method is more accurate for measuing the peak demand of CD customers. (Id. at 32-33)

The Judge accepted NEP's proposal as reasonably accurate for allocating costs required to provide CD service. Staff excepted to the Judge's decision. Staff stated that "adoption of [NEP's] inconsistent allocation procedures for determining the demands for its CD customers results in demand costs that are 'apples' and 'oranges,' and not appropriate for rate development."[61] We agree with Staff, as did the Judge (Id. at 33), that it is preferable to determine the CD customers' demand on the same basis that the total system demand is determined. However, we affirm the Judge's decision for the following reasons. First, NEP's proposal, while not using the best methodology, reasonably reflects the CD customers' demand responsibility.[62] Second, Staff, the only party excepting to the Initial Decision on this point, has presented no evidence on this matter. Finally, as pointed out by NEP in its Brief Opposing Exceptions at 39 (footnote 2), the MRC is the only party which stood to gain from Staff's position since most of the municipals

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[61] Staff's Brief On Exceptions at 15.

[62] NEP's witness testified that a better methodology would be to use the average of 12 months' coincident demands for allocating demand costs to NEP's customers since the annual system peak in December no longer determines NEP's peak capacity requirements (Tr. 1621-1622).

represented by MRC are CD customers; and in accordance with their counsel's representation that MRC would not contest NEP on this issue (Tr. 1628), MRC does not except to the Judge's decision on this matter in the R-10 proceeding.

VII Cost Of Service

In the initial decision (Id. at 33-46) the Judge dealt with a series of cost of service calculations. Except for the "consolidated tax benefits" issue (Id. at 35-37) discussed below, we affirm and adopt the Judge's decision on these issues. For the most part these issues concern the question as to whether any adjustment to NEP's future test year estimates are necessary. The Judge found that adjustments were appropriate where the estimate was without sufficient justification at the time made [63] or where the estimate was erroneous because of some clear error or omission of some kind. [64] The Judge stated his methodology as follows:

> In this proceeding, the cost of service claimed by NEP will be accepted in those areas where there is no valid basis

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[63] For example, the Judge found "that the likelihood of the use of coal was too speculative and uncertain to justify its inclusion in NEP's estimated cost of service." (Id. at 39). Of course, even if the estimates were not unfounded or arbitrary at the time they were submitted, the Commission could still find that it was appropriate to adjust the estimate based on substantial evidence in the record. See *Public Service Co. of Indiana*, Opinion No. 783 as modified by Opinion No. 783-A, affirmed in pertinent part, *Public Service Co. of Indiana* v. *FERC*, No. 77-1238, mimeo at 18-21, (7th Cir. April 27, 1978) where the FPC was upheld in its finding that although the company's estimated purchase power expense was reasonable when made, the FPC's action in not allowing the purchased power expense was proper and based on substantial evidence.

[64] For example, the Judge found that an adjustment was appropriate where there was a clearly identifiable error or omission such as NEP's failure to include certain rental income received from Boston Edison (ID at 43-44). The Judge pointed out that while NEP had included in its rate base its investment in high voltage transmission facilities built to serve Boston Edison, it did not reflect the revenues to be received from the use of these facilities (Exhibit 127).

to question the prudence of NEP's estimates, notwithstanding the fact that actual experience may be different from the estimates used. In those areas where it is argued that NEP exercised imprudent or erroneous judgment, evaluation will be made to consider whether adjustments would be appropriate to insure fairness and equity.

This approach is consistent with the Commission's conclusion set forth on page 17 of slip decision, Opinion No. 783, *supra*, "* * that it would entirely defeat the purpose of the projected test period concept to allow wholesale reworking of the filing utility's estimated costs in light of subsequently discovered actual costs."

Thus, the cost of service components will not be altered in this proceeding solely because there is a variation between estimates and actual data. However, alterations will be made where it appears that NEP estimates were unreasonable or unjustified for the purpose of supporting a reasonable level of rates for NEP in this proceeding. (Id. at 34)

We not only find the Judge's above stated methodology to be reasonable, but we also find his application of this methodology to be fair and equitable, fully supporting a reasonable level of rates for NEP in this proceeding. However, one point was raised in the briefs following the initial decision that warrants further explanation. As noted above, the Judge found that an adjustment was appropriate where there was a clearly identifiable error or omission. However, there were two instances where the omission was clear, but the Judge did not recognize them. The two instances involved were a portion of the Mass Yankee purchased power expense [65] and the capacity deficiency payment to Nepool. We find that it is appropriate not to recognize the above two items because, even though the omission

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[65] NEP, in its Brief on Exceptions at 41 states that "[i]n deriving its estimates, NEP failed to recognize the fact that Mass Yankee had raised its rates on May 1, 1975, some five months before the estimate was compiled."

was clear, the amount of the omission was too uncertain to be recognized based on the record evidence in this case.

As to the Nepool deficiency payments, NEP, at the hearing, first estimated the expense to be between $300,000 and $550,000 (Tr. 1456). Later this amount was estimated to be $300,000 (Tr. 2322). However, even then a NEP witness testified that the Nepool deficiency payments should be offset, at least in part, by recognition of capacity related saving shares from NEPEX (Tr. 2350-2352). NEP did not supply for the record an estimate on the capacity related savings shares from NEPEX. We find this is not the kind of probative evidentiary record required to justify an expense.

As to the portion of the Mass Yankee purchased power expense at issue, NEP, at the hearing, first estimated the expense to be between $500,000 and $600,000 (Tr. 1457). Later, this expense was estimated to be between $400,000 and $800,000 (Tr. 1535). Finally, NEP estimated this expense to be "in the area of $850,000" (Tr. 2086). Again, we find this is not the kind of probative evidentiary record required to justify this expense.

Consolidated Tax Benefits

NEP is directed to revise its calculations on this issue in accordance with *Columbia Gulf Transmission Company, et al.* Docket Nos. RP75-105 and RP75-106, Opinion No. 47, issued July 2, 1979.

VIII Rate Base Issues

A. Method of Computation

The Judge summarized this issue as follows:

> NEP developed its proposed rate base by use of its estimated plant balance as of the beginning of the test year as a base. To this figure, NEP added projected plant additions, deducted projected retirements, and averaged

its anticipated year ending balance with the estimated beginning balance to determine the estimate of its average plant in service during the test year.

Staff review and analysis of NEP's calculations disclose that the estimated beginning year balance used by NEP was in excess of the actual plant account balances as of the start of the test year.

Staff developed an independent rate base calculation based on use of NEP plant book balances as of the beginning of the test year, adjusted for test year additions and retirements as estimated by NEP, with additional adjustments for closeouts of plant prior to the beginning of the test year that NEP had not recorded as of the end of 1975.

Based on the foregoing, Staff submits that NEP's rate base calculation is overstated by $4,406,423.

The methodology used by Staff more accurately reflects the average test year plant upon which NEP is entitled to earn a return and appropriately makes adjustments for components of plant that are no longer in public service.

The foregoing Staff adjustment to NEP's claimed rate base has not been rebutted. This adjustment will be accepted and adopted and NEP's rate base in this proceeding will be reduced accordingly. (Id. at 46-47)

We reverse the Judge on this issue. Both NEP and Staff used a mid year average method in doing their computations.[66] The Staff adjustment[67] adopted by the Judge was disavowed by Staff later in the hearing (Tr. 648, 651).[68] It was appropriate for Staff

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[66] See *Public Service Co. of Indiana*, Opinion No. 783 at 28-29, where the Commission emphasized that the 13 month average method was the preferred method in that it most accurately insured a proper matching of costs and revenues. Fortunately, the record in this case reflects no significant distortion was caused by the use of the less precise mid year average method employed here.

[67] Tr. 630-631.

[68] See Staff's Brief on Exceptions at 15. See also NEP's Brief on Exceptions at 56 which points out that "Staff's [later] presentation adopted NEP's plant account figures (Tr. 651)."

to disavow their earlier presentation (Tr. 630-631) in that the earlier presentation adjusted NEP's estimated plant balance figures through the use of actual figures. We find the Judge's decision inconsistent with the methodology he used in ruling on the cost of service issues (Id. at 33-46). Accordingly, NEP's estimated plant balance figures should be used as no party disputes the reasonableness of these NEP estimates.

B. Working Capital Allowance (Id. at 47-50)

NEP's calculations on this issue must be revised in accordance with our recently enunciated policy in Opinion No. 19-A.[69] Thus, in light of the above and based on our analysis of the record in the instant proceeding, NEP's cash working capital allowance is determined as follows:

(1) PruLease Fuel	$173,205,000 x 20/360[70]	=	$ 9,622,000
(2) Purchased Power	67,946,000 x 19/360[71]	=	3,586,000
(3) All Other O&M	69,169,000 x 45/360	=	8,646,000
Total	$310,320,000		$21,854,000

C. Deferred Income Taxes (Id. at 50-51)

We affirm and adopt the Judge's decision on this issue.

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[69] *Carolina Power & Light Company*, ER76-495, issued February 21, 1979.

[70] The 20 day figure is based on our adopting of the Judge's rationale on this point. (Id. at 47-48).

[71] As to the 19 day figure, see Tr. 266 and Ex. No. 70.

IX Miscellaneous Issues: (1) Alleged Failure Of NARR To Use Pru-Lease Arrangements To Finance Fuel (ID At 51); (2) NEES Capital Contribution To NEP (ID at 52); And (3) Pollution Control Securities (ID At 52-53)

We affirm and adopt the Judge's decision on the above miscellaneous issues. No arguments were raised in the briefs following the Judge's decision which would warrant any modification of the initial decision.

The Commission further finds:

(1) NEP is a "public utility" subject to the provisions of the Federal Power Act, and the sales of power subject to the order which follows as a part of this decision are sales of electric power in interstate commerce for resale, subject to the jurisdiction of the Commission.

(2) NEP's rates, which have been in effect in this docket subject to refund, have not been shown to be just and reasonable or otherwise lawful under the provisions of the Federal Power Act in the respects noted above, and NEP should, therefore, be required to file just and reasonable rates as necessary to conform to this order.

(3) NEP should be required to refund to its jurisdiction customers any amounts reflecting the difference between its proposed rates and the rates required to be filed by this order.

The Commission orders:

(A) The increased rates referred to in Paragraph (2) above are disallowed to the extent that they do not conform to this order.

(B) Within 75 days of the issuance of this order NEP shall file a revised cost of service and any necessary amendments to its rate schedules in lieu of those at issue herein, in accordance with the findings and conclusions of this Opinion and with the Commission's Rules and Regulations.

(C) Within 30 days of the Commission's approval of NEP's substitute tariff sheets in accordance with Paragraph (B), above, NEP shall refund to its customers for the period March 1, 1976, to February 1, 1977, all amounts collected in excess of those which would have been payable under the rates and charges approved in accordance with Paragraph (B) above, together with interest at a rate of nine percent per annum from the date of payment to NEP to the date of refund.

(D) Exceptions not granted are denied.

(E) The Initial Decision is affirmed to the extent not inconsistent with this Opinion and Order.

By the Commissioner

(S E A L)

Separate comment by Commissioners Holden and Hall appended hereto.

Commissioner Holden, having dissented on the *Yankee* cost-of-service tariff adjustment issue, reserves the opportunity to issue a written opinion thereon, subsequent to the issuance of this order.

Kenneth F. Plumb,
Secretary.

NEW ENGLAND POWER COMPANY

DOCKET NOS. ER76-304
ER76-317
ER76-498

Separate Comment by Holden and Hall, Commissioners

In a previous record vote in which we joined, the Commission determined that the final order in this docket should be "held and conformed to" the decision on treatment of consolidated taxes reached in Columbia Gulf (Docket Nos. RP75-105 and RP75-106). That determination was reached by the Commission on June 28, 1979 and expressed in Opinion No. 47, issued July 2, 1979. In our view that decision contains serious error on its merits, and we accordingly dissented.

However, efficiency in the Commission decision-making requires that previously settled procedures should be followed, particularly when all Commissioners have assented to those procedures.

Under the circumstances as indicated, we do not feel obliged to interpose impediment to the implementation of a previous unanimous Commission decision as to the procedure by which this present case would be concluded.

/s/ _____
MATTHEW HOLDEN, JR.
Matthew Holden, Jr.
Commissioner

/s/ _____
GEORGE R. HALL
George R. Hall
Commissioner

APPENDIX A

Some of the relevant components of NEP's rate design, based on its SDP concept, are shown in Exhibit 10 as follows:

Standard Delivery Point:	For purposes of this Tariff, the "Standard Delivery Point" shall be considered to be that point on the integrated generating and transmission system of the Company that first follows one transformation from the power supply system or, by agreement of the parties, a point in close proximity thereto.
Standard Delivery Point Metering Adjustments:	Where delivery is metered at the Company's supply line voltage, in no case less than 69,000 volts, thereby saving the Company transformer losses then, before determining the number of kilowatts and kilowatt-hours to be billed under the preceding provisions, there shall be deducted from the meter registrations of kilowatts and kilowatt-hours for the month in question an amount respectively of one percent (1.0%) of such registrations.

Standard Delivery Point Metering Adjustments: (continued)

Where delivery is metered at the sub-transmission voltage, or at the low side terminals of the transformation from the sub-transmission to the distribution of the customer, and not at the low side terminals of the transformation from the Company's supply line, there shall be added to the meter registrations of kilowatts and kilowatt-hours for the month in question an amount respectively of one and one half percent (1.5%) of such registrations.

Credit and Additional Charge for Delivery at other than Standard Delivery Point:

If delivery is made at the Company's supply line voltage, not less than 69,000 volts, and the Company is saved the cost of installing any transformer and associated equipment there will be allowed a credit of fifteen cents ($0.15) per kilowatt of the demand component at the point of delivery which enters into the computation of the Demand for the District for the month in question. If delivery is made at the subtransmission supply, and not at the low side terminals of the transformation from the Company's supply line, there

will be added a charge of forty six cents ($0.46) per kilowatt of the demand component at the point of delivery which enters into the computation of the Demand for the District for the month in question. The said credit and charge shall be computed after the application of any applicable Standard Delivery Point Metering Adjustments.

APPENDIX B

SUMMARY OF CALCULATIONS OF COST OF EQUITY

A. Discounted Cash Flow Method

1. Moody's Electric Utility Stock Average, Extrapolition of 1956-75 (20 year) Earnings per Share Growth (4.9%), Plus Mean Trailing 12 Month Dividend Yield (8.9%), Plus Pressure Adjustment of 10% to Yield (0.9%) 14.7%

2. Sample of Ten Comparable Utilities: Estimate of Investors' Expected Returns Including Projected Growth of Financial Analysts (4.5%) Mean Trailing 12 Month Dividend Yield (8.5%) Plus Pressure Adjustment of 10% of Yield (0.9%) 13.9%

3. Sample of Ten Comparable Utilities: Estimate of Investors' Expected Returns Including Projected Growth in Earnings and Dividends Through Retained Earnings (4.1%) and Sale of Stock at a Discount (-0.4%) Plus Mean Trailing 12 Month Dividend Yield (8.5%) and Adjusted for Pressure of 10% on Yield (0.9%) 13.1%

B. Premium For Equity Risk Method

1. Premium for Equity Risk on Moody's Electric Utility Stock Average for 1956-76 (4.1%) Plus Trailing 12 Month Yield on Moody's Average Utility Bond (9.5%) 13.6%

2. Premium for Risk 1956-75 (5.2%) Plus Salomon Brothers' Index 10 Year U.S. Treasury Bond Trailing 12 Month (7.7%) 12.9%

3. Premium for Inflation on Moody's Electric Utility Stock Average for 1956-75 (6.5%) Plus Mean GNP Implicit Deflator Trailing 12 Month (6.3%) 12.8%

C. Other

1. Return on Average Equity Ten Comparable Companies Adjusted for Recent Rate Increases Approved 14.0%

2. Correlation Model: Return on Equity Moody's Electric Utility Index Allowing per Share Market Price-to-Book Value Ratio of 110% 14.5%

Unweighted Average 8 calculations	13.7%
Margin of Safety	1.0
Total Cost of Equity Capital	14.7%

NEW ENGLAND ELECTRIC SYSTEM
MONTH-END PRICE-BOOK AND DIVIDEND-PRICE RATIOS

1973-1976

Month/Year	Price-Book Ratio	Dividend-Price Ratio
	(1)	(2)
1973		
January	1.16	6.7
February	1.17	6.6
March	1.12	6.9
April	1.10	7.0
May	1.15	6.8
June	1.10	7.1
July	1.04	7.5
August	1.07	7.7
September	1.11	7.4
October	1.09	7.6
November	0.92	9.0
December	0.89	9.2
1974		
January	0.91	8.6
February	0.95	8.2
March	0.86	9.1
April	0.68	11.5
May	0.66	11.9
June	0.54	14.5
July	0.58	13.6
August	0.59	13.3
September	0.56	14.0
October	0.65	12.1
November	0.62	12.6
December	0.56	14.1
1975		
January	0.72	10.7
February	0.74	10.5
March	0.68	11.3
April	0.69	11.1

1973-1976

Month/Year	Price-Book Ratio	Dividend-Price Ratio
	(1)	(2)
May	0.82	9.4
June	0.82	9.4
July	0.81	9.5
August	0.80	9.6
September	0.77	10.0
October	0.81	9.6
November	0.84	9.2
December	0.85	9.1
1976		
January	0.87	8.9
February	0.87	9.3
March	0.87	9.3
April	0.90	9.0
May	0.86	9.5
June	0.92	8.8
July	0.90	9.0
August	0.94	8.7
September	0.96	8.5
October	0.92	8.9
November	0.98	8.3
December	1.01	8.1

Prices used in calculations are month-end closing prices. Price-book ratios for 1973, 1974 and 1975 use 1972, 1973 and 1974 book value per share, respectively. Price-book ratios for 1976 use 1975 book value per share.

Source:

Col. (1): Derived from data in Standard & Poor's Corporation *Security Owner's Stock Guide*, various issues; *The Value Line Investment Survey*, Edition 5, May 10, 1974 and May 9, 1975; Value Line FUNDAC Data Base; and *The Wall Street Journal*, various issues.

Col. (2): Standard & Poor's Corporation, *Security Owner's Stock Guide*, various issues; and *The Wall Street Journal*, various issues.

APPENDIX C

NEW ENGLAND ELECTRIC SYSTEM
AVERAGE OF 95 ELECTRIC UTILITIES
MONTH-END CLOSING PRICES

1973-1976

Month/Year	Month-End Closing Prices NEES	95 Electric Utilities
	(1)	(2)
1973		
January	$25.00	$25.27
February	25.38	24.73
March	24.25	24.18
April	23.88	23.77
May	24.88	23.65
June	23.75	23.16
July	22.50	22.33
August	23.13	21.83
September	24.00	23.22
October	23.50	21.96
November	19.88	19.38
December	19.25	19.82
1974		
January	20.75	20.59
February	21.63	20.56
March	19.63	19.58
April	15.50	17.18
May	15.00	15.95
June	12.25	14.89
July	13.13	14.99
August	13.38	13.77
September	12.75	13.39
October	14.75	14.47
November	14.13	14.16
December	12.63	13.57

1973-1976

Month/Year	Month-End Closing Prices	
	NEES	95 Electric Utilities
	(1)	(2)
1975		
January	16.63	16.66
February	17.00	16.61
March	15.75	16.21
April	16.00	15.94
May	18.88	16.97
June	19.00	18.67
July	18.75	17.66
August	18.50	17.24
September	17.88	16.98
October	18.63	18.16
November	19.38	18.72
December	19.63	18.88
1976		
January	20.00	20.19
February	20.00	19.32
March	20.00	19.34
April	20.63	19.32
May	19.63	18.51
June	21.13	19.18
July	20.63	19.51
August	21.50	20.22
September	22.00	20.93
October	21.00	20.71
November	22.38	21.15
December	23.00	22.23

Sources: 1973 to May 1974: Standard & Poor's Corporation, *Security Owners Stock Guide*, various issues. June 1974 to December 1976: *The Wall Street Journal*, various issues.

APPENDIX D

ORDER OF THE FEDERAL ENERGY REGULATORY COMMISSION DENYING REHEARING

(Issued March 26, 1980)

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

OPINION NO. 49-A

New England Power Company) Docket Nos. E-8641, *et al.*

New England Power Company) Docket Nos. ER76-304, *et al.*

ORDER ON REMAND, ORDER ON APPLICATION FOR REHEARING, AND ORDER DENYING MOTION FOR STAY

Issued: March 26, 1980

DC-A-28

ELECTRIC RATES:
RATE OF RETURN
COST OF SERVICE
REHEARING STAYS DENIED

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Charles B. Curtis, Chairman; Georgiana Sheldon, Matthew Holden, Jr., and George R. Hall.

New England Power Company) Docket Nos. E-8641 *et al.*
New England Power Company) Docket Nos. ER76-304 *et al.*

OPINION NO. 49-A

ORDER ON REMAND, ORDER ON APPLICATIONS FOR REHEARING, AND ORDER DENYING MOTION FOR STAY

(Issued March 26, 1980)

On July 19, 1979, the Commission [1] issued its "Opinion And Order Establishing Just and Reasonable Rates" (Opinion No. 49) in the above-captioned case. The New England Power Company (NEP), as well as the NEPCO Customers Rate Committee And the Unaffiliated Resale Customers (Customers) filed timely petitions for rehearing. On August 17, 1979, NEP

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[1] This proceeding was commenced before the Federal Power Commission (FPC). By the joint regulation of October 1, 1977 (10 CFR 1000.1), it was transferred to the FERC. The term "Commission", when used in the context of action taken prior to October 1, 1977, refers to the FPC; when used otherwise, the reference is to the FERC.

also filed a motion entitled "Motion of New England Power Company For Partial Stay [Of Refunds] Pending Appeal." NEP's motion was responded to by Customers on September 4, 1979, in a pleading styled "Answer Of The NEPCO Customer Rate Committee And The Unaffiliated Resale Customers to 'Motion Of New England Power Company For Partial Stay Pending Appeal', And Motion To Strike All Portions Of NEP's Application For Rehearing And Motion For Stay Which Are Based Upon Extra-Record Evidence Data." Customers September 4, 1979, filing was responded to by NEP on September 10, 1979.

Meanwhile on August 1, 1979, the United States Court of Appeals for the District of Columbia, remanded certain issues raised on appeal of the Commission Opinion No. 803 orders (Commission Docket Nos. E-8641, *et al.*).[2]

In this order, we will first turn to the above court remand. Then we will deal with the rehearing applications. Finally, we will deal with the NEP motion for partial stay and the various responses and opposing responses engendered by that motion.

I. Order On Remand

The Commission Opinion No. 803 orders concern two rate increase filings by NEP for two successive locked-in periods: January 1 to May 14, 1974, and May 15, 1974 to June 1, 1975. In the Opinion No. 803 orders, the Commission issued a decision, *inter alia*, prescribing NEP's rate of return on common equity as 13.50%, permitting tax normalization by NEP, and affirming the presiding administrative law judge's (judge) finding that NEP's common stock investment in four nuclear power

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[2] *New England Power Company, et al.* v. *Federal Energy Regulatory Commission*, D.C. Cir. No. 77-1884, *et al.*, (D.C. Cir. August 1, 1979).

generating companies (Yankee investments) should be excluded from its capital structure, in particular from the common equity component.[3] NEP and Customers filed petitions for review of the Commission's orders.

The Court remanded the question as to whether NEP may utilize tax normalization so that the Commission could reconsider this question in light of *Public Systems* v. *Federal Energy Regulatory Commission*, D.C. Cir. Nos. 76-1609, 76-1830 (D.C. Cir. February 16, 1979). Since the Commission's finding that 13.5% was a just and reasonable rate of return on common equity in part depended on the tax normalization issue, the Court also remanded the rate of return question.

Finally, the Court stated that because it was remanding the first two questions, and because the justness and reasonableness of the overall rate level is the ultimate question in the proceeding, it would also return to the Commission for further investigation the question of the proper treatment of NEP's Yankee investment in determining the rate of return. The Court stated:

> [W]e recognize that NEPCO ultimately has the burden of proving the constituent elements of its capital structure, and that the company did not refute [Customer witness] Mr. Wiskup's testimony on the exclusion of the Yankee investments. On the other hand, we note that Mr. Wiskup's presentation was nothing more than a bald assertion that he himself deducted the Yankee investments from common equity. Thus, the Commission's conclusion, based on the record before us, rests upon a meagre, if indeed non-existent, evidentiary foundation. Under the circumstances NEPCO should not be precluded from making such showing as it can in support of its burden of proof on this issue.

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[3] NEP had proposed to allocate its Yankee investment pro rata, *i.e.*, if the Yankee investment is to be excluded, it should be excluded pro rata from NEP's capital structure.

A. The Yankee Issue.

We shall consider first the question raised by the Court as to whether NEP's Yankee investment should be excluded from its capital structure. This issue can be broken down into two parts. First, should the Yankee investment be excluded at all? Second, if it should be excluded, from what part or parts of NEP's capital structure should it be excluded?

After reconsideration, we still find the answer to the first question is that the NEP Yankee investment should be excluded from NEP's capital structure. This is so because the NEP Yankee investment is already reflected as common equity in the capital structures of the Yankee plants. Thus, it would clearly be inequitable for NEP, through the Yankee companies, to earn a return on that NEP investment in the Yankee rate proceedings and then for NEP to earn a return on that same investment in the NEP proceedings.[4] In other words, unless the Yankee investment is excluded from NEP's capital structure, the same investment would be taken into account again for ratemaking purposes. To avoid this dual impact, the Commission has consistently excluded the Yankee investments from the capital structures of the sponsoring companies.[5]

Now we come to the second and more seriously contested question, *i.e.* from what part of NEP's capital structure should

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[4] The rates charged NEP by the Yankee companies is reflected in NEP's cost of service as purchased power expense and thus passed through to NEP's customers.

[5] See *Boston Edison Company*, Opinion No. 729, ___ FPC ___ (May 13, 1975). See also *Boston Edison Company*, Opinion No. 53, ___ FERC ___ (July 31, 1979).

the Yankee investment be excluded.[6] Although in the Opinion No. 803 orders we held NEP's Yankee investment should be excluded from NEP's common equity component, we directly addressed this question as a policy matter for the first time in our most recent NEP decision on this matter, Opinion No. 49, issued July 19, 1979. There we stated as follows:

> NEP's method is rejected. To accept its approach would, by direct implication, mean that the full amount of the Yankee investment was financed by a combination of debt, preferred stock and common equity in the same proportions that NEP financed its own rate base. If this were the case, we would have to adjust the capital structures of the Yankee companies to reflect this financing arrangement. Otherwise, the rates established for these Yankee companies would yield returns to their owners in excess of the costs of financing them. This would be a difficult task given the number of participants in these projects. However, our failure to make such adjustments would result in return and tax components of the Yankee costs of service that would be excessive.
>
> The method employed in the initial decision, deducting the amount in question pro rata from common and preferred stock pursuant to Exhibit 73, is also troublesome. It, too, imposes upon the Commission the responsibility to reflect this financing in setting rates for the Yankee companies. We are reluctant to embark on that path. In the case of jointly-owned projects like the Yankee generating companies, investments by the owner-partners should be from common equity capital only. The jointly-owned company should obtain the prudent amounts of debt and preferred stock capital directly from the marketplace. We find

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[6] To exclude the NEP Yankee investments pro rata, as NEP has and continues to advocate, would have no impact on the overall rate of return. On the other hand, to exclude NEP's Yankee investments solely from NEP's common equity has a significant impact on the capital structure ratios and therefore upon the overall rate of return.

> NEP's claimed financing scheme (Exhibit 73), that employed in the initial decision, to be improper and unreasonable for use in setting the proper return and tax components of NEP's cost of service. (mimeo at 25)

Thus by following the above policy of deducting NEP's Yankee investment only from common equity, the Commission avoids an administrative morass[7] (associated with attempts at tracing fungible dollars) and yet has a policy that is fair to all concerned, including NEP. NEP recovers the cost of capital it has invested in its own rate base facilities in the NEP proceeding and NEP recovers the cost of capital invested in the Yankee companies via its share of the Yankee companies' profits. As noted above (footnote 4) the Yankee company profits are derived from charges imposed on "owner-customers" such as NEP, which in turn passes these charges on as purchased power expenses to the ultimate ratepayers.

Further, we find no merit in NEP's arguments that it should be allowed to recoup alleged shortfalls in earnings from the Yankee investments in this proceeding. Again, as we stated in Opinion No. 49:

> As a general principle, the rate of return allowed on NEP's rate base should be based on the cost of the capital devoted to that investment commensurate with the attend-

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[7] There are four separate Yankee Companies and twelve separate sponsoring companies, including NEP. Not all twelve sponsoring companies are involved with each of the separate Yankee Companies. The task of evaluating leveraging by each of the owners for purposes of setting just and reasonable rates of return for these operations would be a difficult and counter-productive one. The policy we have chosen for those types of operations is one which is intended to give the owners incentive to have all non-common equity financing occur at the operation level. In this way, the costs passed on in the cost-of-service tariffs of these operations should reflect the true costs of these operations and nothing more.

> ing risks. Likewise, the allowed return on the Yankee company rate bases should be based on their capital costs commensurate with their risks. We cannot and do not make a determination in this proceeding that the risks and allowed rates of return on common equity should be the same for all of NEP's investments. NEP's arguments are based on the premise that it is.[8] (mimeo at 25-26)

Finally, we point out that in Opinion No. 49 NEP again had a chance and failed to make a persuasive showing in support of its burden of proof in this issue. Further, we see no need for any additional evidence from NEP since we addressed the question from a policy standpoint in Opinion No. 49 and we perceive nothing which NEP could present in the way of evidence that would warrant any revision of our fundamental conclusions there. Thus, we reaffirm our holding in the Opinion 803 orders to exclude NEP's Yankee investment from the common equity component to NEP's capital structure.

B. The Tax Normalization Issue

The Court remanded the question as to whether NEP may utilize tax normaliztion so that the Commission could reconsider this question in light of the recent *Public Systems* decision.[9] Pursuant to that decision, we have issued an "Order Establishing Interim Procedures"[10] to facilitate the handling of cases

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[8] The various parts of a company often impose differing risks and therefore, justify a higher or lower return than would be appropriate for the company as a whole. See e.g. *Hampshire Gas Company*, "Order Affirming In Part And Modifying In Part Initial Decision," Docket No. RP75-97, March 21, 1979; *Kentucky West Virginia Gas Company*, Opinion No. 7 ___ FERC ___ (February 16, 1978); *National Fuel Gas Supply Corporation*, Opinion No. 58, ___ FERC ___ (August 6, 1979).

[9] *Public Systems* v. *F.E.R.C.*, Nos. 76-1609 and 76-1830 (D.C. Cir. February 16, 1979).

[10] Docket Nos. R-424 and R-446 (June 8, 1979).

that arise while we are reexamining Order No. 530-B. In accordance with that order, NEP is permitted to retain, subject to refund, that portion of its rate increase which reflects the effects of tax normalization of timing differences encompassed by Order No. 530-B. If, on remand of the *Public Systems* case, the Commisson announces a new policy, further proceedings will be necessary both on the tax normalization issue and on its effect on the rate of return in Opinion No. 803.[11] Thus, in the meantime, the status quo is maintained.

II. Order On Applications For Rehearing

The parties raise numerous objections relating to the majority of issues decided in Opinion No. 49. For the most part, these objections represent restatements of the same or similar objections previously made to the judge and to the Commission on exceptions to the initial decision. Except for the three issues discussed below, the Commission finds that the arguments raised in the rehearing applications do not warrant further discussion.

A. Tax Normalization

Customers question whether the Commission has taken into account its approval of comprehensive inter-period tax alloca-

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[11] The interrelationship between rate of return and tax normalization is well recognized. See Order No. 530 where the Commission stated:

> The adoption of normalization of income taxes for rate purposes will contribute to the health of the electric and natural gas industries by increasing cash flow and by reducing external financing requirements. In addition, normalization will contribute to the financial stability of companies and improve fixed charge coverages. (mimeo at 10)

See also *Boston Edison Company*, Opinion No. 809, ____ FPC ____ (July 6, 1977) where the Commission stated that "consideration of the salutory effects of tax normalization upon the utility's cash flow in establishing rate of return follows Commission practice." (mimeo at 10)

tion in setting NEP's rate of return. The answer is that the Commission did take this into account in setting NEP's rate of return. Our discussion on this issue above in connection with Opinion No. 803 is equally applicable here. If, on remand of the *Public Systems* case, the Commission announces a new policy, further proceedings will be necessary both on the tax normalization issue and on its effect on rate of return. [12]

B. Accumulated Deferred Investment Tax Credit (ADITC) Funds

NEP, for the first time in this proceeding in its rehearing filing, raises a question on this issue. NEP requests that the return on ADITC funds be measured by the return on common equity. This request is denied. We have consistently held that the return on ADITC must be measured by the overall rate of return, rather than by the higher common equity return. [13]

C. Yankee Cost-Of-Service Tariff Issue

We have reviewed the applications for rehearing by the NEPCO customers and by NEPCO and have thoroughly reconsidered the portion of Opinion No. 49 dealing with rate of return in light of these applications. The customers' arguments have led us to revise our analysis to some extent, but with no change in result; and NEP's arguments have led us to change the result slightly, although not due to any change in our reasoning.

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[12] See also, *Southern California Edison Company*, Opinion No. 62, ___ FERC ___ (August 22, 1979); *Alabama Power Company*, Opinion No. 54, ___ FERC ___ (August 1, 1979); and *Public Service Company of Indiana*, Opinion No. 44, ___ FERC ___ (June 28, 1979).

[13] *Carolina Power and Light Company*, Opinion No. 19, August 2, 1978 (mimeo, pp. 6-10). *See also, Virginia Electric Power Company*, Docket No. ER78-522, Order issued August 30, 1978; and *Public Service Company of Oklahoma*, Docket No. ER78-511, Order issued October 12, 1978.

Customers first attack the Commission's conclusion that the Yankee cost-of-service tariff effects a shift in risk from the Yankees to NEP. Upon analysis, we find considerable merit to customers' argument. Second, customers argue that by granting NEP-operating a higher rate of return on equity than was found necessary for NEES, the Commission is attempting to provide "an improper guarantee of earnings to shareholders." We believe this argument to be without merit. The analysis leading us to both conclusions is set out below.

Seven rate of return witnesses testified in this proceeding. To one extent or another, all of them used NEES as a proxy for NEP. (The only witness whose analysis seemingly focused directly on NEP was Dr. John Wilson, witness for customers, who employed a comparable earnings approach using NEP rather than NEES.) It is less than perfectly clear from the record whether these witnesses were using NEES as a proxy for NEP as a whole, including NEP's investment in and earnings from the Yankees (NEP-composite), or if they were using NEES as a proxy for NEP exclusive of investment in and earnings from the Yankees (NEP-operating). It might be argued that even NEP's witnesses were talking about NEP-operating rather than NEP-composite, since the proceeding was concerned with setting the rates for NEP-operating alone, rather than NEP-composite. However, we do not believe this characterization to be fair or accurate. Although we find a fatal defect in NEP's approach, we think it clear that NEP was seeking a determination of the proper rate of return for NEP as a whole in this case.

In earlier decisions,[14] the Commission determined that NEP's investment (and that of other utilities) in the Yankees

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[14] See *Boston Edison Company*, Opinion No. 53, issued July 31, 1979; *New England Power Company*, Opinion No. 803, issued June 6, 1977; and *Boston Edison Company*, Opinion No. 729, issued May 13, 1975.

would not be allowed in NEP's rate base or capital structure. In this case, NEP witnesses argued against excluding NEP-Yankee investments from total (composite) NEP capital structure. The implication of this observation is that when they used NEES-based information to estimate a rate of return value, it was a value intended to be applied to *both* the capital invested in NEP's own rate base and the capital invested in the Yankees. Consequently, although the witnesses did not explicitly state this, such a rate of return value probably is intended to reflect NEP-composite rather than just the NEP-operating component. We note, for example, that NEP Witness Benderly's direct testimony listed common equity at $288,984,425 which is (rounded) the $289 million figure we used for NEP-*composite* investment in Opinion No. 49.

We explained in Opinion No. 49 why NEP's use of the overall capital structure for both NEP-operating and the investment in the Yankees is not appropriate. Having determined that NEP's recommended method for taking the Yankee investment into account is not satisfactory does not, however, lead unavoidably to the conclusion that customers' recommended approach (application of NEES' rate of return directly to NEP-operating) is correct.

In Opinion No. 49, the Commission relied primarily on a DCF analysis applied to NEES, and concluded that NEES' appropriate rate of return would be 12.75%. The Commission was then directly confronted with the question of whether NEES should be used as a proxy for NEP-composite or for NEP-operating. As noted above, this was a distinction which NEP's witnesses did not address because of the inclusion of the Yankee investment in NEP's capitalization.

Customers' witnesses, on the other hand, were somewhat inconsistent in their treatment of cost of capital and the capitalization base to which the cost was applied. Dr. Wilson did not exclude the return from the Yankees in his comparative earn-

ings analysis of NEP, so that he was not really isolating NEP-operating in his rate of return determination. [15] Mr. Miller also made a DCF analysis of NEES based in part on NEES' investment in and return on the Yankees (through NEP). (Also, some of the other utilities in Mr. Miller's 88-firm sample have an investment in, return from, and operating contracts with, one or more of the Yankees.) Mr. Miller did not exclude the Yankee investment from his analysis of NEES' cost of capital nor did he allude to the investment as carrying a different risk that would require an adjustment in the NEES analysis. Yet he applied his result to NEP's capitalization, after having *excluded* the NEP investment in the Yankees.

The Commission's approach, which falls somewhere between that of NEP and the customers, is really quite straightforward: we find that NEES more closely resembles NEP-composite than it does NEP-operating. The investment in and earnings from the Yankee investment is a component of NEES and a component of NEP-composite; it is not a component of NEP-operating. Thus, we conclude that the rate of return we have determined appropriate for NEES is also appropriate for NEP-composite. [16] The rest of the analysis is simply arithmetical: if NEP-composite is to have an opportunity to earn 12.75%, and the portion of NEP-composite reinvested in the Yankees is earning approximately 10%, then the return from NEP-

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[15] Exhibit 96.

[16] Customers contend that this conclusion, and the calculation that follows from it, is without record evidence. There is certainly sufficient record evidence to permit an evaluation of whether NEP-operating or NEP-composite more closely resembles NEES. Moreover, as discussed above, several elements of the customers' case fail to exclude NEP-Yankee and thus undercut customers' contention that the record evidence deals solely with NEP-operating.

operating must be in excess of 12.75%. This approach does not, as customers contend, result in an equalization of return on investment for NEP-operating and NEP-Yankees. Neither does it flow from a perception that the respective risks are equal. To the contrary, implicit in the approach is a recognition that the risk and appropriate returns are different. Furthermore, by this process, the Commission has not improperly guaranteed earnings to shareholders, as the customers have argued. Instead, the rate of return determination represents no more than a measure of NEP-operating's cost of capital, given what we know about NEES shareholders' risks and required returns.

Hence, as we now analyze this matter, the shift in risk effected by the cost-of-service tariff, while it may be a major cause of the risk differential, does not enter into the calculation of the appropriate return for NEP-operating. That is, the fact that the Yankees have succeeded in shifting a great deal of their risk to others (be they the Yankees' utility customers or the customers of those utilities) is a vital consideration in determining the risk of an investment in the Yankees. But it does not, strictly speaking, enter into our analysis under a market-oriented approach of the appropriate return for NEES as a proxy for NEP.

It is true that one might compare the determined return for the Yankees to that for NEP-operating to see if the rate of return differential seemed to be consistent with the relative risks of the two investments — that is, as a check on the result of the use of NEES as a proxy for NEP-composite and the subsequent disaggregation of NEP-composite. In this case, however, that inquiry cannot be made very precisely. For the most part, the Yankees' returns were established by settlement rather than final Commission opinion. Also, different test years were employed as the basis for the various rates.

Finally, in a further attempt to undo some of the confusion that may have been created by Opinion No. 49, we explicitly

disavow the use of the word "adjustment" in our discussion to describe the calculation by which we derived the appropriate rate of return of NEP-operating. As we believe the foregoing discussion makes clear, we do not find that NEES' rate of return is different from that of NEP-operating because of an adjustment to NEP-operating's rate of return to take further account (above and beyond that resulting from the application of the DCF analysis) of a shift in risk; rather, the difference comes about through a disaggregation of the components of NEP-composite and calculation of the simple weighted average of the respective components' rates of return to deduce the implied rate of return of NEP-operating. This is not an "adjustment" to any value.

Turning to NEP's application for rehearing, we must acknowledge the validity of two points raised therein. Both involve recalculation of the NEP-operating rate of return, and together they increase slightly our value over what we had found just and reasonable in Opinion No. 49.

First, NEP notes that it must pay taxes on its return on its (equity) investment in the Yankees. NEP argues that the 10% return figure used by the Commission in its derivation of NEP-operating's rate of return is a pre-tax number (from NEP-composite's viewpoint), whereas a post-tax figure should be used. It appears that NEP is correct on this point, so that an adjustment to convert the 10% return to a post-tax basis is warranted.

Using NEP's information that 15% of NEP-Yankees's rate of return is taxable for NEP at the 48% corporate income tax rate and Opinion No. 49's pre-tax NEP-Yankee rate of return of 10%, the after-tax Yankee rate of return is deduced as follows (all values are percentages): [17]

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[17] Section 243 of the Internal Revenue Code, which specifies an 85% tax exclusion for common equity dividends, is our reference for deducing the federally taxable income to NEP.

Pre-Tax Yankee Rate of Return	Taxable Portion: 15% of 10%	Tax: 48% of Col. (2)	After-Tax Yankee Rate of Return (1) - (3)
10	1.5	0.72	9.28

This last value (9.28%) would now replace Opinion No. 49's ten percent NEP-Yankee rate of return in a new derivation of NEP-operating's rate of return.

NEP's second point is that Account 216.1 (Unappropriated Undistributed Subsidiary Earnings) should be included in the Yankee investment under Opinion No. 49's methodology. We agree; this sum ($4.5 million) is correctly a part of the NEP-Yankee investment and should be added to the $34.2 million used in Opinion No. 49, giving now a total NEP-Yankee investment of $38.7 million. Combining this with NEP-operating's investment of $254.8 million yields a NEP-composite capital of $293.5 million. This means that 86.8% of NEP-Composite investment is in NEP-operating, and 13.2% is in NEP-Yankee. The equation in Opinion No. 49's footnote 34 can now be written as a weighted sum of each component's rate of return. NEP-operating's rate of return is thus derived using these investment percentages and the 9.28% after-tax NEP-Yankee rate of return as:

$$(0.1275) = (0.0928)(0.132) + (r)(0.868)$$

which gives $r = 0.1328$, or *13.28%* as our revised NEP-operating rate of return.

Footnote 17 cont.

Two aspects of NEP's argument are *not* adopted here. First, NEP calculates a weighed average of the book rates of return cited in Opinion No. 49 as 9.4% and advocates this as the pre-tax "gross" rate of return which should be adjusted. It is questionable that such value can legitimately be the expected rate of return needed, as indicated by footnote 33 of Opinion No. 49. Secondly, NEP calculates an after-tax rate of return of 8.5%, even starting with Opinion No. 49's ten percent pre-tax value. It appears that NEP calculated just the taxable portion of the rate of return but forgot to compute the applicable tax itself.

In light of the above discussion, NEP's capitalization table should now read as follows:

	Amount (000)	Capital Ratios (%)	Cost Rates (%)	Weighted Component (%)
Long Term Debt	$435,000	54.32	7.34	3.99
Preferred Stock	111,028	13.86	7.51	1.04
Common Equity	254,806	31.82	13.28	4.23
	$800,834			9.26

Thus, we find 9.26% to be a just and reasonable overall rate of return for NEP-operating during the relevant locked-in period. We believe this return, determined primarily on the basis of market cost of common equity considerations,[18] to be commensurate with returns on investments in other enterprises which have similar risk, and to be sufficient to assure confidence in NEP-operating's financial integrity so that it can maintain its credit and attract capital.

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[18] We note, as a point of information, that this distinguishes the present proceeding from the R-7 and R-8 proceedings dealt with in Opinion No. 803. Although the Commission deduced a higher numerical value than did the Administrative Law Judge, it based its decision there on the Judge's approach. The Judge's reasoning, in turn, was grounded virtually totally on comparable earnings analysis in the record, but modified in an important way. Specifically, the Judge explicitly excluded investments in the Yankee atomics from NEP's common equity and then relied on the resulting lower equity ratio to arrive at a rate of return on common equity higher than the comparable earnings witness had recommended. It is thus clear that in Opinion No. 803, the Commission evaluated a rate of return by using just NEP-operating information and applied its value to just NEP-operating. Consequently, it was not necessary to deduce NEP-operating's rate of return from NEP-composite's value as had to be done here. Furthermore, the adjustments we have made here to reflect a post-tax NEP-Yankee rate of return and Account 216.1 additional Yankee equity would not have arisen in Opinion No. 803. These adjustments are specific to our approach here.

III. Order Denying Motion For Partial Stay Of Refunds (Opinion No. 49)

On August 17, 1979, NEP filed a motion requesting a partial stay of the Commission's refund order contained in Opinion No. 49 pending the outcome of appeal of Opinion No. 49. NEP requests a stay of refunds associated with the issues it raises in its Application For Rehearing (filed August 17, 1979). [19]

NEP contends that its requested stay meets the test laid down by *Virginia Petroluem Jobbers Association* v. *F.P.C.*, 259 F.2d 921 (D.C. Cir. 1958) as recently modified in *Washington Metropolitan Area Transit Commission* v. *Holiday Tours, Inc.*, 559 F.2d 841 (D.C. Cir. 1977).

The Commission has been guided by the criteria in *Virginia Jobbers, supra,* in ruling on motions for stay. In order to satisfy the test laid out by the Court an applicant must make a strong showing that it is likely to prevail on the merits of its appeal, it must show that without such relief it will be irreparably injured, that an issuance of a stay would not substantially harm other parties interested in the proceedings, and that the public interest supports the issuance of a stay. *Virginia Jobbers* must now be read in conjunction with *Holiday Tours, supra,* in which the Court declined to read the probability of success criterion in an exceedingly precise, technical sense:

> Instead, we hold that under *Virginia Petroleum Jobbers* a court, *when confronted with a case in which the other*

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[19] Customers filed a motion on September 4, 1979, opposing NEP's motion for stay. Customers contend, among other things, that NEP's motion is totally inconsistent with judicial precedent and Commission decisions on stays pending appeal.

Customers' filing of September 4, 1979, also contained a motion to strike all portions of NEP's application for rehearing and motion for stay which are based upon extra-record data. In light of the Commission's denial of NEP's application for rehearing and motion for stay, Customers' motion is moot.

> *three factors strongly favor interim relief* may exercise its discretion to grant a stay if the movant has made a substantial case on the merits. The court is not required to find that ultimate success by the movant is a mathematical probability, and indeed, as in this case, may grant a stay even though its own approach may be contrary to movant's view of the merits. The necessary "level" or "degree" of possibility of success will vary according to the court's assessment of the other factors. 559 F.2d at 843 [Emphasis added].

NEP asserts that consumers will not be harmed by a stay while NEP may be irreparably harmed if it makes refunds now. NEP further argues that "the public interest in this proceeding also lies in avoiding the disappointment, cumbersome administrative procedures, and potential litigation that might arise if a surcharge for recoupment is eventually found to be necessary" (NEP motion at page 5).

The commission finds that a stay is not merited under the criteria of *Virginia Petroleum Jobbers Ass'n* v. *F.P.C.*, 259 F.2d 921 (D.C. Cir. 1958) and *Washington Metropolitan Area Transit Commission* v. *Holiday Tours, Inc.*, 557 F.2d 241 (D.C. Cir. 1977).[20] NEP has not demonstrated that it will be irreparably harmed if it makes refunds now. If the Commission is reversed, either this Commission or the courts may provide NEP with a remedy to recover the refunded amounts. Because corrective or compensatory relief is available in the ordinary course of litigation, the Commission has consistenly found that

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[20] Although we are using these criteria as a guide for our decision here, we note that they are not necessarily exclusive or inclusive criteria for determining whether a stay is appropriate in all cases before this Commission.

making refunds before judicial review is completed will not cause irreparable harm. [21]

Further, NEP's assertion that its customers will not be harmed because they will eventually get their refunds overlooks the fact that the protection afforded by refunds may be inadequate to fully protect the consumers' interest, *F.P.C.* v. *Hunt*, 376 U.S. 515, 524-25 (1964). Moreover, delayed refunds may not totally compensate customers for the actual cost of money later refunded, and delay diminishes the possibility that those who paid these excessive rates would be those who ultimately receive the refunds. *F.P.C.* v. *Tennessee Gas Co.*, 371 U.S. 145, 154 (1962). The *Tennessee Gas* case held, citing *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 388 (1959), *prompt* refunds were required "to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges."

NEP argues that its customers will not be harmed because they will eventually get the refunds. Yet NEP believes it will be subject to irreparable harm if it now has to make refunds that are subject to later recovery by NEP if it prevails on appeal. As *Virginia Jobbers, supra* at 925 states:

> Relief saving one claimant from irreparable injury, *at the expense of similar harm caused another*, might not qualify as the equitable judgment that a stay represents (emphasis supplied).

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[21] See *e.g. Tennessee Natural Gas Lines, Inc. et al.*, Docket Nos. RP71-11 *et al.* (PGA76-1) (order issued April 23, 1979); *Cities Service Gas Company*, Docket No. RP79-4 (order issued January 29, 1979); *Public Service Company of Indiana*, Docket No. ER78-513 (order issued January 8, 1979); *Area Rate Proceedings, et al.* (Southern Louisiana Area), Docket Nos. AR61-2 *et al.* (orders issued June 27, 1978 and July 31, 1978); *Jersey Central Power & Light Company*, Docket No ER76-813 (order issued January 20, 1978).

We believe that in proceedings such as this the public interest supports the rapid disbursement of refunds ordered by the Commission. The authority given to the Commission to determine the justness and reasonableness of rates is for the protection of the public interest as distinguished from the private interests of utility companies. *F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956). In protecting the consumer, the Commission's primary mission is to assure the lowest possible reasonable rates consistent with the maintenance of adequate service. *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 611 (1941). The Commission's orders in this proceeding do this.

In *Holiday Tours, supra*, the court modified one part of the *Virginia Jobbers* test. It eased the standard for determining whether a petitioner has made a strong showing that it is likely to prevail on the merits of an appeal. In order for a petitioner to come within the ambit of this modified test, it must show that the other three factors strongly favor a granting of a stay. [22] In the instant proceeding NEP has not made such a showing sufficient to warrant a stay.

The Commisson orders:

(A) Within 30 days of the issuance of this order NEP shall file a revised cost of service and any necessary amendments to its rate schedules in lieu of those at issue herein, in accordance with the findings and conclusions of this order and with the Commission's Rules and Regulations.

(B) Except to the extent granted herein, the arguments raised in the applications for rehearing filed to the Commission's Opinion No. 49 and accompanying order are denied.

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[22] *Washington Metropolitan Area Transit Commission* v. *Holiday Tours, Inc.*, 559 F.2d 841 at 843.

(C) NEP's motion for partial stay pending judicial review, filed August 17, 1979, is denied.

By the Commission. Commissioner Holden, dissenting, will have a separate statement to be issued later.

(S E A L)

Kenneth F. Plumb,
Secretary.

APPENDIX E

ORDER OF THE FEDERAL ENERGY REGULATORY COMMISSION IN W-2 PROCEEDINGS, ISSUED DECEMBER 31, 1979

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Georgiana Sheldon, Acting Chairman,
Matthew Holden, Jr.,
and George R. Hall.

NEW ENGLAND POWER COMPANY	) DOCKET NOS.	ER80-66
	)	ER80-67
	)	ER80-68

ORDER ACCEPTING FOR FILING AND SUSPENDING PROPOSED RATES, DENYING MOTION TO REJECT, GRANTING IN PART AND DENYING IN PART MOTIONS FOR SUMMARY JUDGMENT, GRANTING WAIVERS, GRANTING INTERVENTIONS, CONSOLIDATING PROCEEDINGS AND ESTABLISHING PROCEDURES

(Issued December 31, 1979)

On November 1, 1979, New England Power Company (NEPCO) submitted in Docket No. ER80-66, a proposed change in its service agreement with its affiliate, full-requirements customer Narragansett Electric Company (Narragansett).[1] The two affiliates have an integrated facilities

[1] New England Electric System (NEES) is the parent company of NEPCO, a wholesale generation and transmission company, and three retail electric companies: Narragansett (Rhode Island), Granite State Electric

arrangement whereby Narragansett's separate generation and transmission (G&T) facilities are made available to NEPCO in return for certain G&T credits on power purchases. The proposed rate changes increase these credits by $2,907,700 annually, based on the Period II test year ending December 31, 1980. The applicant requests that the proposed rate changes be made effective on January 1, 1980, and that any suspension period be no greater than one day. NEPCO requests waiver of the Commission's filing requirements under Sections 35.13(b)(1)[2] and 35.13(b)(4)(iii)[3] of our Regulations.

In Docket No. ER80-67, NEPCO tendered for filing amendments to its wholesale power tariff (W-2), which is comprised of two parts: one rate for contract demand (CD) service and another rate for primary service. The proposed changes would increase NEPCO's revenues from the CD customers by $2,088,000 for the calendar 1980 test year.[4] Revenues from the primary service customers will be increased by $48,792,000.[5] NEPCO further requests that the W-2 rate be made effective on

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Company (New Hampsire) and Massachusetts Electric Company. NEES is also the parent of New England Energy Incorporated, a fuel company, and New England Power Service Company.

[2] Submission of revenue comparision data.

[3] Submission of Periods I and II cost of service data.

[4] NEPCO's CD customers are the Massachusetts municipalities of Ashburnham, Danvers, Georgetown, Groton, Hingham, Holden, Ipswich, Littleton, Mansfield, Marblehead, Middleton, Paxton, Peabody, Shrewsbury, Sterling, Wakefield, West Boylston, Hull, North Attleboro, Princeton and Templeton. NEPCO proposes to increase the demand charge from $8.22/kW/month to $10.33/kW/month with the energy charge remaining at 14 mills/kWh. There is no change in the fuel adjustment clause.

[5] The affiliated primary service customers are: Massachusetts Electric Co., Narragansett, and Granite State Electric Co. Unaffiliated Customers are: Groveland (Mass.) Municipal Electric Light Department; Littleton (New Hampshire) Water & Light Department; Manchester (Mass.) Electric Company; Merrimac (Mass.) Light Department; New Hampshire Electric

January 1, 1980, and that it be suspended for no more than one day.

NEPCO also tendered for filing on November 1, 1979, in Docket No. ER80-68, changes in the demand charge for its system power unreserved (SPU) service. These proposed changes would increase revenues to NEPCO by $1,773,114, based on the 1980 test year.[6] NEPCO requests an effective date of January 1, 1980, and permission to incorporate in this docket Statements A through I and K submitted with the W-2 rate filing. NEPCO further states that consolidation of Docket Nos. ER80-67 and ER80-68 would be appropriate because of the commonality of cost support.

Notice of NEPCO's filings in the three dockets was issued on November 6, 1979, with comments due by November 27, 1979. *See* Attachment A for rate schedule designations.

On November 23, 1979, the Attorney General of the State of Rhode Island and the Rhode Island Division of Public Utilities and Carriers filed a petition to intervene in Docket No. ER80-67 (W-2 rate), and requested that the proposed rate changes be rejected or, in the alternative, suspended for five months.

Corporative, Inc.; Green Mountain (Vermont) Power Corporation; United States Department of the Army, Fort Devens (Mass.). NEPCO proposes to increase the demand charge from $6.79/kW/month to $7.85/kW/month and the energy charge from 17.55 mills/kWh to 18.43 mills/kWh. The fuel adjustment clause is not changed.

[6] The non-affiliate SPU customers include: Village of Lyndonville, Vermont; Green Mountain (Vermont) Power Corporation; Fitchburg (Mass.) Gas and Electric Light Company; Hudson (Mass.) Light and Power Department. NEPCO's non-affiliated CD customers (footnote 2, *supra*) also take SPU service. The SPU demand charge would be increased from $4.192/kW/month to $5.33/kW/month. CD rates are subject to a fuel charge equal to NEPCO's average monthly fuel cost per kwh, adjusted for monthly energy transactions.

On November 27, 1979, Fitchburg Gas & Electric Light Company (Fitchburg) petitioned to intervene in Docket No. ER80-68 and in any consolidated dockets. Fitchburg states that it is currently the largest single purchaser of SPU power and energy, although this service will terminate on October 31, 1980. Therefore, Fitchburg states that NEPCO's SPU rate improperly reflects certain long-term costs, in particular expenses to amortize NEPCO's abandoned generating units. (Salem Harbor No. 5 and NEES Nos. 1 and 2) and costs related to NEPCO's proposed conversion of the Salem Harbor and Brayton Point generating stations from oil to coal. Fitchburg requests that the Commission suspend the proposed SPU rate for five months.

Fitchburg also asks the Commission to direct that NEPCO immediately amend its filing and rates to correct certain mathematical errors that overstate NEPCO's production O&M expense. Fitchburg further seeks the summary elimination from NEPCO's proposed SPU rates of costs attributable to PURPA[7] load research and expenses associated with Electric Power Research Institute (EPRI) and Liquid Metal Fast Breeder Reactor Program (LMFBR) support payments.

On November 27, 1978, the NEPCO Customer Rate Committee and the unaffiliated resale customers (Customers) filed a protest, petition to intervene, motion to reject, motion for summary judgment and request for consolidation of the three dockets.[8] The Customers also request that the proposed rates be suspended for five months if the filings are not rejected.

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[7] Public Utility Regulatory Policies act of 1978.

[8] By letter dated November 28, 1979, the Committee and Customers submitted two pages that were inadvertently omitted from their November 27 pleading. By letter filed on November 29, 1979, the Customers requested leave to submit an affidavit and related material to supplement their pleadings. We shall consider their petition as amended by the supplemental materials. An answer was also filed by these customers on December 13, 1979.

Motion To Reject

In support of their motion to reject the filings, the Customers state that NEPCO has included certain coal handling and other related costs in its Period II cost of service which are supported only by unsubstantiated assumptions. Based on our review we find that NEPCO's submittals substantially comply with our filing regulations. Accordingly, the motion to reject is denied.

Motions For Summary Disposition

Customers request summary disposition of various items. Summary disposition shall be granted as to the following issues, as discussed *infra:*

(1) treatment of NEPCO's unamortized investment in the Salem Harbor No. 5 and NEES Unit Nos. 1 and 2 projects;

(2) calculation of the income tax component of Narragansett's G&T credits;

(3) treatment of NEPCO's ADITC balances in computing a federal income tax deduction for long term debt;

(4) treatment of NEPCO's PURPA load research costs; and

(5) correction of technical errors in NEPCO's cost calculations.

All other issues raised by the intervenors must be resolved during the course of an evidentiary hearing. We find that the motion to strike certain portions of the testimony of NEPCO's witnesses is best addressed to the presiding administrative law judge to be assigned to this case.

(1) Abandonment Costs Relating to Salem Harbor No. 5 and NEES Unit Nos. 1 and 2.

In Opinion No. 49 we held that it was improper for NEPCO to include in rate base its unamortized investment in the cancell-

ed Salem Harbor No. 5 project. NEPCO has not offered any reason to suggest that the decision should not apply to its latest filings. This precedent also controls NEPCO's proposal to include in rate base the unamortized investments in two other abandoned generating projects, NEES Nos. 1 and 2. Accordingly, rate base treatment is hereby denied as to NEPCO's unamortized investment in Salem Harbor No. 5 and NEES Unit Nos. 1 and 2. [9]

NEPCO proposes to amortize some $31 million of investment in NEES Nos. 1 and 2 over a five-year period. Any question regarding the prudence of NEPCO's investment, together with the appropriate amortization period for this investment, will be resolved during the evidentiary hearing to be held in this case. [10]

(2) Calculation of the income tax component of Narragansett's G&T credits.

In Opinion No. 49, we determined that the income tax component of the G&T credit may not include additional taxes

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[9] The prepared tetimony of NEPCO's Executive Vice President Mr. Browne (at 8) indicates that NEPCO's 1973 load forecasts predicted the need for two large nuclear units in the early 1980's. The units constituted a major part of NEPCO's generation planning for the 1980's and were originally scheduled to be completed in March 1982 and November 1983. Mr. Browne states that since the project was begun, dramatic increases in the price of oil, economic and other factors have combined to hold growth rates well below the historic rates that were used as a basis for the original planning. Mr. Browne further states that NEPCO and its affiliated companies have developed a long range plan, called NEESPLAN, which has as one objective the reduction of peak load growth to 1.9 percent annually over the 1980-85 period through a program of conservation and load management. According to Mr. Browne, if the plan is successful, it would delay the need for operation of major new capacity additions such as NEES Unit Nos. 1 and 2 beyond 1995.

[10] In Opinion No. 49 we held that a 5-year period was appropriate to amortize NEPCO's investment in its Salem Harbor project.

arising from the excess of book over tax depreciation on Narragansett's generating facilities. We recognized that in developing the G&T credit, NEPCO has, since 1967, been normalizing the difference between tax and book depreciation. Thus, NEPCO's wholesale customers have *not* been the beneficiaries of the additional tax deduction when tax depreciation exceeded book depreciation. As we found in the prior case, it is now inappropriate for the wholesale customers to bear the burden of additional tax expense when book depreciation exceeds tax depreciation. NEPCO does not suggest any reason or allege any fact that would support a departure from the treatment specified in Opinion No. 49. Accordingly, NEPCO's method of computing the income tax component of the Narragansett G&T credits is rejected.

(3) Treatment of ADITC in computing a long-term debt Federal income tax deduction.

The Customers seek summary disposition as to NEPCO's treatment of ADITC in calculating its Federal income tax interest deduction regarding long-term debt. The Customers allege that NEPCO's method of interest synchronization differs from the method approved by the Commission in Opinion No. 54, *Alabama Power Company* (August 1, 1979). That method computes an interest deduction by multiplying an electric utility's rate base (not reduced by an ADITC balance) by its weighted long-term debt cost (derived from a capital structure that does not include ADITC). The Customers maintain that NEPCO's method is improper because, although NEPCO uses a weighted long-term debt cost derived from a capital structure that does not include ADITC NEPCO computes its interest deduction by multiplying this debt cost by a rate base that is reduced by its ADITC balance. The Customers maintain further that NEPCO's method is inconsistent with permitting NEPCO to earn a return on ADITC at its overall return rate determined without regard to ADITC.

NEPCO responds in its answer of December 7, 1979, stating that ADITC funds are interest free and do not generate interest deductions for tax purposes. NEPCO rejects the Customers' notion that it must treat ADITC as interest bearing just because the return it earns on ADITC includes a component attributable to long-term debt. NEPCO further states that permission to earn such a return is not recognition that ADITC funds are to be treated, for rate purposes, as if they were interest bearing.

In order to resolve this issue, reference is made to Section 46(f) of the Internal Revenue Code[11] and to the related IRS regulations approved March 15, 1979.[12] The Code and the underlying regulations specify the Congressionally mandated restrictions as to the allowed rate treatment of investment tax credits. Section 46(f) provides that "no credit shall be allowed" unless the regulatory body permits the specified ratemaking treatment of the credits.

Section 46(f) provides various options as to the rate treatment of investment tax credits. The section permits the taxpayer, *i.e.* the regulated utility rather than the regulatory body, to choose among the available options. Sections 46(f)(1), (2) and (3) describe the options available to electric utilities. In the present case NEPCO has chosen the option set forth in Section 46(f)(2) of the Code. In pertinent part, the Section states:

> . . . no credit shall be allowed [by the IRS] . . .
>
> (A) If the taxpayer's *cost of service* for ratemaking purposes or in its regulated books of account is reduced by *more than a ratable portion* of the credit allowable . . . *(determined without regard to this subsection)*, or
>
> (B) If the *base* to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason

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[11] 26 U.S.C.A. § 46(f) (1979 Supp.).

[12] *See*, 44 Federal Register 17666-17672 (March 23, 1979).

> of any portion of the credit allowable . . . *(determined without regard to this subsection).* (Emphasis added).

Thus the option, selected by NEPCO prohibits any rate base reduction but allows a ratable cost of service reduction over the life of the asset that generates the credit.

The IRS regulations for Section 46(f) provide guidance in determining what rate treatment satisfies the requirements of the Code. With regard to the requirement of paragraph B of Section 46(f)(2), IRS Reg. § 1.46-6(b)(3)(ii) states:

> In determining whether, or to what extent, a credit has been used to reduce rate base, reference shall be made to any accounting treatment that affects rate base. In addition, in those instances in which the rate of return is based on the taxpayer's cost of capital, reference shall be made to any accounting treatment that affects the *permitted* return on investment by treating the credit in any way other than as though it were capital supplied by common shareholders to which a "cost of capital" rate is assigned that is *not less than the taxpayer's overall cost of capital rate (determined without regard to the credit)* . . . Thus, for example, an overall cost of capital rate may be determined on the basis of an average, or *weighted average of the costs of capital provided by common shareholders, preferred shareholders and creditors.* (Emphasis added).

Thus, by permitting NEPCO to earn, as it claims, a return on its ADITC balances at the permitted overall return determined without regard to the tax credits, the Commission satisfies the requirement of paragraph B.

Underlying the IRS regulations is the Treasury Department's interpretation of the intent of Congress as to Section 46(f). The Treasury's explanation of the regulations (44 Fed. Reg. 17666-67) recognizes that portions of the legislative committee reports accompanying Section 46(f) suggest the tax credits be treated as capital contributions by common shareholders and must be assigned the same cost of capital as all other capital contributed

by such shareholders. However, in adopting the requirement that the credits be permitted to earn a return at the utility's overall rate, the Treasury Department points to two goals that the ratemaking limitations of Section 46(f) were intended to achieve: "a sharing of benefits between consumers and investors and a limitation of Federal revenue losses." The Treasury's explanation of the regulation further states:

> Under certain circumstances, the common shareholder equity rule would deny consumers any of the benefits and could force ratemaking authorities to set rates higher than rates that would have been established had no credit been available. Under such circumstances Federal revenue losses would not be merely limited to the amount of the credit, but would be reduced to an amount less than the credit. Congress did not intend to force consumers to subsidize the cost of the investment tax credit. (Emphasis added).

Thus, the overall return requirement was adopted as most consistent with Congressional intent.

The issue as to the proper treatment of ADITC for purposes of computing an interest deduction must therefore be resolved by determining whether NEPCO's treatment of ADITC or method approved in Opinion No. 54 conforms with the requirments of paragraph A of Section 46(f)(2). The Commission believes that in determining whether a particular treatment results in a cost of service reduction greater than a ratable reduction of ADITC, reference must be made to a utility's cost of service determined as if investment tax credits were not available. This approach parallels Section 46(f)(2) of the IRS Code and the regulations.

We must assume that if such credits were not available, NEPCO would have financed that part of its rate base now supported by ADITC with a combination of debt and equity in

the same proportion as is reflected in its capital structure.[13] Opinion No. 19 at 9, *Carolina Power & Light Co.* (August 2, 1978). Federal income tax expense should, therefore, reflect the interest deduction that would then have been available absent ADITC. The point or base tax expense level from which the Commission may deduct the full amount of the annual amortization of ADITC in determining the cost of service. The difference between NEPCO's cost of service determined in the absence of tax credits and the cost of service using the Opinion No. 54 method is the ratable portion of the allowable investment tax credit. Thus, the Opinion No. 54 method precisely reflects the ratable cost of service reductions permitted by Section 46(f)(2)(A) of the Internal Revenue Code.

NEPCO's method, on the other hand, by reducing the amount of interest in computing a tax allowance for ratemaking purposes, increases the tax expense and cost of service so as to offset the benefits to consumers arising from a revenue requirement that is reduced by a ratable portion of the credit. As a result, the benefits to investors would be increased. NEPCO's

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[13] It would clearly be impossible to determine exactly what other financing a utility might have arranged in the absence of the investment tax credit. Moreover, many things in addition to the method of financing might be expected to change as well: the total capitalization, construction programs and schedules, other aspects of tax liability, the mix of capital costs and expenses faced by a utility etc. The exercise of constructing a model "alternative utility" that might have evolved in the absence of investment tax credits is therefore so speculative and highly academic as to be pointless. Yet the fact remains that the proper basis for determining if a particular ratemaking treatment is consistent with the Internal Revenue Code and Regulations is this alternative utility. The only administratively feasible aproach is to assume that nothing except the source of cash would have changed if the credits had not been available. The Commission has thus determined that, for ratemaking purposes, it will be assumed that in the absence of investment tax credits a utility would have financed the ADITC portion of its rate base with the same proportions of debt and equity, reflected in its capital structure by which it has financed the remainder of its rate base.

method thus diminishes the ratepayers' share of ADITC benefits below the level permitted by Congress under Section 46(f)(2). In fact, in certain circumstances, NEPCO's method would eliminate all benefits of the credits to consumers and would cause the Commission to fix a revenue requirement that is higher than would be fixed absent the availability of investment tax credits. NEPCO's method would thus force consumers to subsidize the tax credits contrary to the intent of Congress as recognized by the IRS regulations.

NEPCO's method of computing an interest deduction for long term debt is therefore summarily rejected. The interest synchronization method approved in Opinion No. 54 and advocated by the Customers in this case is hereby adopted. This method is found to be most consistent with Congressional intent. [14]

(4) PURPA Load Research Expenses.

Fitchburg and the Customers submit that NEPCO's inclusion of PURPA load research expense in its Period II cost of service should be summarily rejected. Each cites the Commission's Order No. 48 [15] as requiring this summary treatment. NEPCO responds by stating that if it is not allowed to pass through a portion of these customers may escape any payment of such costs although the PURPA research will be of benefit.

Section 290.104 of our regulations provides:

> The cost of complying with the reporting requirements of this part shall not be allowed by the Com-

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[14] Our discussion and summary disposition of this ADITC issue elaborates on, and is intended to provide further clarification of, our order on rehearing in *Public Service Company of New Mexico*, Docket Nos. ER79-478 and ER79-479 (December 18, 1979).

[15] Collection of Cost of Service Information under Section 133 of the Public Utility Regulatory Policies Act of 1978, issued September 28, 1979, Docket No. RM79-16.

mission in establishing rates for the sale of electric energy at wholesale under Part II of the Federal Power Act. [16]

Accordingly, NEPCO is directed to remove all costs associated with PURPA load research from its cost of service for all its wholesale customers. If NEPCO is conducting PURPA research on behalf of its affiliated resale customers, the costs incurred should be recovered under a fee arrangement rather than by its wholesale rates.

(5) Technical Corrections.

Fitchburg and the Customers both request that NEPCO be summarily required to make certain technical corrections in its submittals. These requests are hereby granted. We note that NEPCO has indicated in its response that it will correct its operation and maintenance expense calculation, exclude the EPRI expenses from the cost of service, and submit revised rates before January 1, 1980.

CONCLUSION

Our review of NEPCO's submittals in each of the three dockets indicates that the proposed rate changes have each not been shown to be just and reasonable, and may be unjust, unreasonable, unduly discriminatory, or otherwise unlawful. Based on this review and having carefully considered the reasons offered in each of the pleadings as to whether the proposed rates should be rejected or suspended, we shall accept NEPCO's proposed rates in Docket Nos. ER80-66 and ER80-67 for filing, suspend the effectiveness of each for five months and permit each to become effective on June 1, 1980 subject to refund. We shall also grant all petitions to intervene as well as NEPCO's requests for waiver of certain of our filing require-

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[16] Final Regulations, Docket No. RM79-6 (June 5, 1979); and Order No. 48 (September 28, 1979).

ments. Docket Nos. ER80-66, ER80-67 and ER80-68 shall be consolidated for purposes of hearing and decision.

The Commission Orders:

(A) The motion to reject the NEPCO filing is hereby denied.

(B) NEPCO's request for waiver of Sections 35.13(b)(1) and 35.13(b)(4)(iii) of the Regulations is hereby granted.

(C) NEPCO's request to incorporate by reference certain cost data pursuant to Section 35.19 of the Regulations is hereby granted.

(D) NEPCO's proposed rates in Docket Nos. ER80-66 and ER80-67, as refiled to comply with our summary dispositions, are hereby accepted for filing, and suspended for five months, and permitted to become effective on June 1, 1980 subject to refund at the outcome of the proceeding. NEPCO's proposed rates in Docket No. ER80-68, as refiled to comply with our summary dispositions, are hereby accepted for filing and suspended for one day, to become effective on January 2, 1980, subject to refund.

(E) Motions for summary disposition are hereby granted in part and denied in part as specified in this order. Within thirty days from the date of this order NEPCO shall refile its rates and cost support to reflect the summary disposition.

(F) All petitions to intervene are hereby granted, *Provided, however,* that participation by the intervenors shall be limited to the matters set forth in their petitions to intervene and *Provided, further,* that the admission of intervenors shall not be construed as recognition by this Commission that they might be aggrieved by any order entered in this proceeding.

(G) Docket Nos. ER80-66, ER80-67 and ER80-68 are hereby consolidated.

(H) Pursuant to the authority contained in and subject to the jurisdiction conferred upon the Commission by § 402(a) of the Department of Energy Act and by the Federal Power Act, and pursuant to the Commission's Rules of Practice and Procedure and Regulations under the Federal Power Act, a public hearing shall be held concerning the justness and reasonableness of NEPCO's proposed rates.

(I) Staff shall serve top sheets in the proceeding on or before April 1, 1980.

(J) A presiding administrative law judge, to be designated by the Chief Administrative Law Judge for that purpose, shall convene a conference in this proceeding to be held within 10 days of the serving of top sheets, in a hearing room of the Federal Energy Regulatory Commission, 825 North Capitol Street, N.E., Washington, D.C. 20426. The presiding administrative law judge is authorized to establish procedural dates and to rule on all motions (except motions to consolidate or sever and motions to dismiss) as provided for in the Commission's Rules of Practice and Procedure.

(K) The Secretary shall promptly publish this order in this Federal Register.

By the Commission.

(S E A L)

Kenneth F. Plumb,
Secretary.

ATTACHMENT A

Page 1 of 2

New England Power Company
Docket Nos. ER80-66, ER80-67 and ER80-68

Filed: November 1, 1979

	Designation	Description
(1)	13th Revised Sheet No. 1 and 14th Revised Sheet No. 2 of Schedule II-A under FPC Electric Tariff, Original Vol. No. 1 (Supersedes 12th Revised Sheet No. 1 and 13th Revised Sheet No. 2)	Rate W-2
(2)	7th Revised Sheet No. 1 and 8th Revised Sheet No. 2 of Schedule II-CD under FPC Electric Tariff, Original Vol. No. 1 (Supersedes 6th Revised Sheet No. 1 and 7th Revised Sheet No. 2)	CD Service
(3)	Supplement to Service Agreement under FPC Electric Tariff, Original Vol. No. 1	Amendment with Narragansett
(4)	7th Revised Sheet No. 4 under (3) above	G&T credits
(5)	2nd Revised Sheet No. 1 of Schedule II-C under FPC Electric Tariff, Original Vol. No. 2 (Supersedes 1st Revised Sheet No. 1)	System Power-Unreserved
(6)	Supplement No. 2 to Rate Schedule FPC No. 286 (Supersedes Supplement No. 1)	Revised Page No. 5 with Village of Lyndonville

(7) Supplement No. 1 to Rate Schedule FPC No. 288	Revised Page No. 5 with Green Mountain Power Corporation
(8) Supplement No. 2 to Rate Schedule FPC No. 302 (Supersedes Supplement No. 1)	Revised Page No. 7 with Fitchburg Gas & Electric Light Company
(9) Supplement No. 2 to Rate Schedule FERC No. 308 (Supersedes Supplement No. 1)	Revised Page No. 10 with Town of Hudson

Narragansett Electric Company

(10) Supplement No. 8 to Rate Schedule FPC No. 38 (Supersedes Supplement No. 7) (Concurs in (3) and (4) above)	G&T credits

APPENDIX F

ORDER DENYING APPLICATION FOR REHEARING

(Issued February 13, 1980)

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

ELECTRIC RATES: REHEARING

Before Commissioners: Charles B. Curtis, Chairman; Georgiana Sheldon, Matthew Holden, Jr., and George R. Hall.

NEW ENGLAND POWER COMPANY	) DOCKET NOS.	ER80-66
	)	ER80-67
	)	ER80-68

ORDER DENYING APPLICATION FOR REHEARING

Issued: February 13, 1980

DC-A-60

Various applications for rehearing and related pleadings have been filed concerning the Commission's suspension order issued in these dockets on December 31, 1979. The pleadings in part relate to New England Power Company's (NEPCO) planned program of energy management and conservation, including the conversion of its Brayton Point and Salem Harbor generating units from oil to coal.

On January 14, 1980, NEPCO filed an application for rehearing. NEPCO requests a reduction of the five-month suspension period ordered by the Commission with regard to the proposed change in its service agreement with its affiliate, Narragansett Electric Company (Narragansett) in Docket No. ER80-66, and the proposed increase in its W-2 rates in Docket No. ER80-67. NEPCO also requests that the Commission reverse the summary disposition of the following issues: (1) abandonment costs relating to Salem Harbor No. 5 and NEES Unit Nos. 1 and 2, (2) calculation of the income tax component of Narragansett's G&T credits, and (3) the treatment of accumulated deferred investment tax credits (ADITC) in computing a federal income tax deduction for long-term debt.

On January 22, 1980, Fitchburg Gas and Electric Light Company (Fitchburg) filed its rehearing application. Fitchburg objects to the one day suspension of the proposed rate increase for system power unreserved (SPU) service in Docket No. ER80-68, and the inclusion in the SPU cost of service of certain long-term coal conversion costs and other costs related to the abandonment of Salem Harbor No. 5 and NEES Unit Nos. 1 and 2. On January 28, 1980, the NEPCO Customer Rate Committee and unaffiliated customers (customers) filed their rehearing application generally concerning the same issues raised by Fitchburg. On January 24, 1980, the United States Department of Energy (DOE) filed pursuant to Section 405 of the Department of Energy Organization Act (P.L. 95-91) a

notice of intervention and preliminary comments concerning NEPCO's coal conversion program. [1]

With regard to our summary disposition of the G&T credit issue, we shall deny NEPCO's application for rehearing. Our summary action on this issue was based on Opinion No. 49. [2] NEPCO has applied for rehearing of that opinion, and our denial of rehearing here shall be subject to our consideration of the same issue in connection with Opinion No. 49. As to the ADITC issue and our determination that it is improper for NEPCO to include in rate base its investment in the abandoned Salem Harbor and NEES unit, we have carefully reviewed NEPCO's application and have concluded that no new arguments have been raised that would warrant rehearing of our prior order.

Further, we have reviewed the suspension period of the proposed rates for SPU service. In this regard we find that our one-day suspension of these rates is appropriate.

We shall also deny rehearing, requested by Fitchburg and the customers taking SPU service, on the question whether NEPCO's long-term coal conversion costs and abandoned property costs for Salem Harbor No. 5 and NEES Unit Nos. 1 and 2 should be reflected in the SPU cost of service. Fitchburg and the Customers essentially argue that these costs are not related to the SPU service and will not benefit the SPU customers. We find that these matters involve questions of fact and policy that are best resolved after the development of an evidentiary record in this proceeding.

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[1] On January 7, 1980, the Massachusetts Department of Public Utilities and the New Hampshire Public Utilities Commission filed a joint notice of intervention pursuant to Section 1.8 of the Commission's Rules of Practice and Procedure. They raise no substantive matters in their notice.

[2] *New England Power Company*, issued July 19, 1979.

NEPCO has also requested that the Commission grant rehearing of the five-month suspension period found to be appropriate for the proposed rate changes in Docket Nos. ER80-66 and ER80-67. NEPCO states that the five-month suspension will preclude its recovery of approximately 42% of its coal conversion expenditures for the 1980 calendar test year, although its customers will immediately obtain the benefits of lower fuel costs through operation of the company's fuel adjustment clause. NEPCO characterizes the five-month suspension period as being unresponsive to a national policy of achieving energy independence.

NEPCO's coal conversion program involves the burning of coal for a limited time pursuant to environmental waivers (short-term conversion) and the burning of coal on a permanent basis in full compliance with all applicable environmental regulations (long-term conversion). NEPCO's efforts involve its Brayton Point (Units 1, 2 and 3) and Salem Harbor (Units 1, 2 and 3) generating plants. Short-term conversion will not occur at Salem Harbor Unit 1 and Brayton Point Unit 3.

NEPCO states it received final approval in May of 1979 to convert its Brayton Point units to coal on a long-term basis and that the conversion is scheduled for completion in 1981. NEPCO also states that it hopes to convert the Salem Harbor units to coal on a long-term basis.

As to its short-term conversion program, NEPCO states it is now burning coal at its Brayton Point Units 1 and 2 under the terms of a Delayed Compliance Order issued under Section 113(d)(5) of the Clean Air Act (42 U.S.C. § 7413(d)(5)) and may continue to do so at least until August, 1980. With regard to the Salem Harbor units, NEPCO apparently has not yet started to burn coal, although it estimates it could burn coal through the 1980 test year provided it receives the requisite regulatory approvals.

NEPCO's Exhibit No. ____ (NE-404) submitted with its rate increase filing reveals estimated revenue requirements of about $11.5 million to cover fuel handling, O&M expenses and conversion costs of its program during 1980. Of this amount $2.7 million is associated with the long-term conversion program. In addition NEPCO seeks the inclusion in rate base of approximately $32 million of coal conversion construction work in progress that would generate approximately another $6 million. Thus, the total revenue request associated with the coal conversion is approximately $17 million. NEPCO claims that the additional coal conversion costs will not be offset by any significant savings in other items such as fuel inventory. NEPCO estimates that by burning coal it its Brayton Point Units 1 and 2 for seven months during 1980 its customers will save about $20 million.

NEPCO requests the Commission to suspend the company's proposed rate changes in Docket Nos. ER80-66 and ER80-67 for one day, or a period significantly shorter than five months. NEPCO also apparently favors the reduced suspension period approach over one proposed by the customers who endorse a waiver of Order No. 517 [3] to permit NEPCO to recover actually incurred fuel conversion costs through its fuel adjustment clause.

DOE states in its pleadings that the Commission should adopt procedures which allow prompt and full recovery of prudently-incurred coal conversion costs. In so doing, DOE says, a major objective of national energy policy — reducing our nation's reliance on scarce fuels — would be furthered. DOE indicates various alternative means of allowing a utility to recover coal conversion costs, but does not endorse any particular mechan-

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[3] Order Amending Section 35.14 of the Regulations Under the Federal Power Act, Docket No. R-479, issued November 13, 1974. The customers have endorsed a time-limited waiver of § 35.14 of the Regulations that now prohibits recovery of fuel handling costs through a fuel adjustment clause.

ism in this case. DOE further states that if the Commission does adopt the shortened suspension period approach advocated by NEPCO, then a shorter period should apply *only* as to those prudently-incurred conversion costs that are not offset by cost savings to the utility related to conversion efforts. DOE also suggests that in order for the Commission to act promptly in accordance with this approach, rate increase filings should segregate out the conversion expenditures and related costs savings from the overall request.

The Commission is sympathetic to some of the problems underlying NEPCO's request for rehearing of our suspension order. NEPCO should be commended for undertaking its load management and energy conservation programs. We note in this regard that NEPCO hopes to reduce its peak load growth and defer the need for new generating capacity additions until 1995. Further, the Commission believes that NEPCO should be permitted prompt and full recovery of its net coal conversion costs so long as its customers obtain the benefits of conversion through fuel savings passed through by NEPCO's fuel adjustment clause.

However, a shortening of the five-month suspension period, as NEPCO advocates, cannot be granted as our preliminary analysis of NEPCO's proposed rates in Docket Nos. ER80-66 and ER80-67 indicate that the rates are substantially excessive, even assuming that NEPCO would fully recover all of the filed coal conversion related costs, and that therefore the full statutory suspension is warranted. Although a portion of the proposed increase is based on costs related to NEPCO's coal conversion program, which would further national energy goals, our determination of a suspension period must be based on an analysis of the total rate level proposed for a particular type of service rather than on a few isolated cost components.

In recognition of the benefits of its coal conversion, energy conservation and load management programs, NEPCO, if it so

chooses, may file within three weeks of the date of this order a supplement to its original rate increase filing to include an interim rate increase to recover only the costs directly related to its coal conversion program. The Commission could then entertain a motion for waiver of our notice requirements under Section 35.11 of our Rules and Regulations, and for acceptance of the supplement for filing as of January 1, 1980. Section 35.17(b) of the regulations could be waived if the supplement is otherwise accepted for filing. The supplement should provide detailed information which identifies the components of NEPCO's cost of service that are directly related to its coal conversion program. Costs related to the Brayton Point program and those for Salem Harbor should be separately identified. Upon review of this supplement, the Commission will consider the appropriateness of a one-day suspension period so that an interim rate would become effective on January 2, 1980, subject to refund.

This action we believe will encourage and foster energy conservation, load management and coal conversion programs similar to those of NEPCO. Because these efforts further national energy goals, we shall, consistent with our general statutory responsibilities, continue to explore alternatives to permit the prompt recovery of net costs directly related to ongoing programs. In the present case, however, we note that NEPCO could have but chose not to avail itself of the opportunity to submit supplementary cost data (of the type described) at the time of its original rate filing. In so doing, NEPCO placed in jeopardy the costs related to its conversion programs together with its other costs of service.

Accordingly, we shall deny NEPCO's application for rehearing without prejudice to the submission of an interim rate supplement as described.

The Commission Orders:

(A) All applications for rehearing are denied; however, denial of NEPCO's application as to the suspension period in Docket Nos. ER80-66 and ER80-67 is without prejudice to NEPCO's filing a supplement to its original rate increase filing as described herein.

(B) The Secretary shall promptly publish this order in the Federal Register.

By the Commission.

(S E A L)

Lois D. Cashell,
Acting Secretary.

APPENDIX G

SECTION 205 OF THE FEDERAL POWER ACT, 16 U.S.C. § 824d.

§ 824d. Rates And Charges; Schedules; Suspension Of New Rates

(a) All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No public utility shall, with respect to any transmission or sale subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every public utility shall file with the Commission, within such time and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with

the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint or upon its own initiative without complaint, at once, and, if it so orders, without answer or formal pleading by the public utility, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the public utility affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of such five months, the proposed change of rate, charge, classification, or service shall go into effect at the end of such period, but in case of a proposed increased rate or charge, the Commission may by order require the interested public utility or public utilities to keep accurate account in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts are paid, and upon completion of the hearing and decision may by further order

require such public utility or public utilities to refund, with interest, to the persons in whose behalf such amounts were paid, such portion of such increased rates or charges as by its decision shall be found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the public utility, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

June 10, 1920, c. 285, § 205, as added Aug. 26, 1935, c. 687, Title II, § 213, 49 Stat. 851.

CERTIFICATE OF SERVICE

I hereby certify that I have this 15th day of March, 1982, caused to be served the foregoing Petition for a Writ of Certiorari, by mailing three copies of said Petition to the parties to the proceeding at the following addresses:

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Opposition

Office - Supreme Court, U.S.
FILED
MAY 19 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-1708.

In the
Supreme Court of the United States.

OCTOBER TERM, 1981.

NEW ENGLAND POWER COMPANY,
PETITIONER,

v.

FEDERAL ENERGY REGULATORY COMMISSION, ET AL.,
RESPONDENTS.

ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

Brief in Opposition of Respondents, Dennis J. Roberts, II, Attorney General of the State of Rhode Island and the Rhode Island Division of Public Utilities and Carriers.

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No. 81-1708.

In the

Supreme Court of the United States.

OCTOBER TERM, 1981.

NEW ENGLAND POWER COMPANY,
PETITIONER,

v.

FEDERAL ENERGY REGULATORY
COMMISSION, ET AL.,
RESPONDENTS.

ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

Brief in Opposition of Respondents, Dennis J. Roberts, II, Attorney General of the State of Rhode Island and the Rhode Island Division of Public Utilities and Carriers.

These respondents, Dennis J. Roberts II, Attorney General of the State of Rhode Island and the Rhode Island Division of Public Utilities and Carriers, respectfully request that this Court deny the petition for writ of certiorari, seeking review of the District of Columbia Circuit's opinion in this case. That opinion is not yet reported, but a copy thereof is provided in Appendix A to the petition for certiorari.

Reasons Why the Writ Should be Denied.

1. The Court Below Fully Considered and Correctly Decided the Issues Raised by Petitioner.

Petitioner herein, a wholesale power producing company affiliated with retail distribution companies in Rhode Island, New Hampshire and Massachusetts,[1] seeks to go beyond FERC's decision to permit the recovery, from the customers of all of the capital invested in the cancelled generating units.[2] NEP now seeks to further require those customers to pay a return on such capital until it is recovered. Both FERC and the Court below found that recovery of such a return was barred by the longstanding rule that only items which are "used and useful" in providing utility services may be included in rate base and thus earn a return. NEP seeks to avoid this "used and useful" requirement by arguing that its property is being "taken" without compensation if the "used and useful" standard is upheld as a requirement for such a return.

At the outset, FERC below agreed with the Administrative Law Judge's conclusion that:

> "There is no precedent, or reasonable justification in the record of this proceeding, to require ratepayers to pay

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[1] In its petition, NEP suggests that it has a statutory obligation under Rhode Island statutes "to insure the availability of sufficient generating capacity to meet its customers demands. See e.g., R.I. Gen. Laws § 39-1-1 (1977)." Petition at 3, n.2. In fact, the requirement of the cited section is imposed upon NEP's Rhode Island retail affiliate, not on NEP. That section gives Rhode Island no authority over NEP and imposes no obligation on NEP.

[2] Under current FERC rates, NEP's customers are not paying for four cancelled nuclear projects, including Salem Harbor # 5, NEES Unit Nos. 1 and 2, Montague Unit Nos. 1 and 2 and Pilgrim Unit No. 2. None of these plants has ever produced a kilowatt of electricity.

a return on an expenditure that has not resulted in productive plant that is used or useful in the public service." Petitioner's Appendix C, p. C-32.

The District of Columbia Circuit affirmed, stating in part that:

> "NEP says capital prudently invested in a generating facility is taken for public use and therefore must be included in the rate base. That view had its genesis in a dissenting opinion of Mr. Justice Brandeis in *Pacific Gas & Electric Co.* v. *San Francisco*, 265 U.S. 403 (1924). This court has recognized, however, that Justice Brandeis' formula for ascertaining rate base — the amount of capital prudently invested — was not to become the prevailing rule." *Democratic Central Committee* v. *Washington Metropolitan Area Transit Commission*, 158 U.S. App. D.C. 7, 485 F.2d 786, 801 (1973), *cert. denied sub nom., D.C. Transit System, Inc.* v. *Democratic Central Committee*, 415 U.S. 935 (1974).
>
> The general rule recognized by this court is that expenditure for an item may be included in a public utility's rate base only when the item is "used and useful" in providing service; that is, current rate payers should bear only legitimate costs of providing service to them." Petitioner's Appendix A, pp. A-8 to A-9.[3]

These Respondents can find no constitutional infirmity in the challenged action.

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[3] See also: *Tennessee Gas Pipeline Co.* v. *FERC*, 196 U.S. App. D.C. 187, 606 F.2d 1094 (1979); *cert. den.* 445 U.S. 920 (1980); *cert. den.* 447 U.S. 922.

Initially NEP seeks to establish that the health of the electric utility industry, as a whole, somehow requires that NEP be successful herein. NEP's petition at 5-6 and n.4. NEP goes so far as to quote from a June 1981 speech by Dr. Alfred Kahn to the effect that the electric utility industry was in a "crisis", and "a profound failure" in its financial performance. Yet, at the same time, the following article appeared at page 29 of the July 2, 1981 issue of "Public Utilities Fortnightly:"

> "Lights Not Going Out"
>
> The financial outlook for America's investor-owned electric utility industry is growing brighter rather than darker, a group of the industry's leaders told the British and European investment communities in London on June 19th. Speaking to a seminar with the theme, "The lights are not going out for America's electric utilities," Edison Electric Institute President William McCollam, Jr., and other industry executives and regulators painted a picture of generally improving regulatory, political, and financial conditions for the electric utilities. The seminar was sponsored by Dean Witter Reynolds Overseas Ltd. as its "answer" to a pessimistic article in The Economist on February 28th, entitled "The lights are going out for America's electric utilities." Not so, say EEI's McCollam and others. "While we recognize our problems as serious and are striving to solve them, the new climate for doing so, especially that in Washington, is greatly improved."

The respondents simply wish to point out that there are contrary points of view on the health and well-being of the electric utility industry and, in any case, that is really not the issue before this Court.

NEP also notes that this problem has been resolved differently in different jurisdictions and suggests that consequently it is somehow necessary that this Court issue a uniform rule. On the contrary, the federal regulatory agency decisions below, and the appeals therefrom, reflect complete support for the application of the "used and useful" requirement. The different results described by NEP simply reflect the result in other jurisdictions of the application of different statutory and regulatory schemes to a variety of facts and circumstances and not necessarily a constitutional quandary. As the Court noted in *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942):

> The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority to make the pragmatic adjustment which may be called for by particular circumstances.[4]

The Court should not disturb this creative flexibility given that the ultimate result is always subject to the requirement of *Hope*, *supra*; that it is the reasonableness of the end result which is the final protection for a utility.

Petitioner also misreads the Commission's decision when it concludes that "FERC recognized that investors were never compensated for assuming this risk (that the plant, if not used and useful, would not be included in rate base and thus not

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[4] *Accord*: *Federal Energy Regulatory Commission* v. *Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979); *Permian Basin Area Rate Cases*, 390 U.S. 747, 797 (1968); *Wisconsin* v. *Federal Power Commission*, 373 U.S. 274, 309 (1963); and *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("*Hope*").

earn a return) (App. C, p. 35)." NEP's petition at 9. In fact, FERC concluded that NEP's investors had not received a return for the risk that they would not recover their investment (as opposed to a return thereon) in the cancelled plant. Accordingly, FERC granted NEP a full recovery of its investment through cost of service. Since FERC did not permit NEP to earn a return over time through rate base, FERC must have concluded that the risk of exclusion from rate base as not "used and useful" was a risk for which the investors had already been compensated through their equity returns. This is a logical conclusion, since the "used and useful" rule is one of longstanding.[5] Therefore, there is no factual basis for NEP's claim that it has had its property "taken" without compensation.

2. NEP Fails to Explain How the Balance of Interests in *HOPE* Should be Adjusted to Reflect Current Utility Regulation.

NEP proposes that the *Hope* decision be somehow updated to reflect current conditions. Yet, NEP fails to explain either how the existing result is inconsistent with *Hope* or how *Hope* should be modified in view of changed circumstances. Likewise, the record suggests little in the way of a sound factual

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[5] The Court should be careful to recognize that utility investors receive an equity return for accepting a bundle of risks. Some of those risks, although perceived to be slight, may in fact come to pass and cause substantial losses. It is simply not sufficient to argue that the perceived (or ignored) risk was so small that it is somehow wrong to require the company to accept the loss. Otherwise, the customers would become insurers of all risks not expressly identified and of all excess losses over the perceived risk. This is simply not consistent with reasonable risk analysis and with the balance of interests between the utility and its customers.

basis for trimming *Hope's* sails to fit what may well be short term problems.

The Court should avoid disturbing the balance of interests reached in the *Hope* case, because that balance has served for nearly forty years as a reasonable standard for the review of public utility ratemaking decisions. When something fairer appears, then the Court should, indeed, seek to refine the standard of review. However, this case is simply not an appropriate vehicle therefor.

Conclusion.

For these reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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May 17, 1982.

Opposition

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No. 81-1708

In the Supreme Court of the United States

OCTOBER TERM, 1981

NEW ENGLAND POWER COMPANY, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether the Federal Energy Regulatory Commission properly determined that a public utility was not entitled to earn a return on an expenditure for a project that failed to result in facilities that were "used or useful" in the public service.

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BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A-1 to A-45) is reported at 668 F. 2d 1327. The opinions and order of the Commission (Pet. App. C-1 to C-64, D-1 to D-22 and E-1 to E-18) are not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on October 15, 1981. A petition for rehearing was denied on November 24, 1981 (Pet. App. B-1 to B-2). On January 11, 1982, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 14, 1982, and the petition was filed on March 15, 1982 (a Monday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 313(b) of the Federal Power Act, 16 U.S.C. 825*l*(b).

STATUTE INVOLVED

Section 205 of the Federal Power Act, 16 U.S.C. 824d, is set forth at Pet. App. G-1 to G-3.

STATEMENT

1. Petitioner, New England Power Company, is a public utility that generates and sells electricity at wholesale in interstate commerce, subject to regulation by the Federal Energy Regulatory Commission under the Federal Power Act, 16 U.S.C. 791a *et seq.* In 1971 petitioner began preparations to construct an oil-fired electric generating facility, the Salem Harbor Unit No. 5, to meet its estimated generating capacity (Pet. App. A-7). The project was cut short by an unforeseeable chain of events set in motion by the October 1973 oil embargo imposed by the Organization of Petroleum Exporting Countries. The embargo resulted in skyrocketing fuel costs, which led to the adoption of energy conservation measures and to a reduction in petitioner's anticipated load growth and future capacity requirements (*id.* at A-7 to A-8). In response to these developments, petitioner suspended engineering and construction activity on the Salem Harbor unit in February 1974, and cancelled the project on November 18, 1975 (Pet. 3). By that date petitioner had incurred expenses of about $13 million (Pet. 3).

Petitioner deducted the loss on the Salem Harbor unit in its 1975 tax return, thereby lowering its taxes by approximately $6 million and reducing its $13 million loss on the project to about $7 million (Pet. App. C-30 to C-31). In addition, petitioner filed a new wholesale rate schedule with the Commission, in which it proposed to recover its $13 million investment in the cancelled facility over a five-year amortization period (*id.* at C-31). Petitioner also sought to earn a return on the $13 million investment during the

amortization period by including the unamortized balance of the investment in its rate base (*ibid.*).[1]

2. Following an evidentiary hearing on petitioner's application for a rate increase, an administrative law judge allowed petitioner to amortize all of its net (after tax) loss of approximately $7 million over a ten-year amortization period (Pet. App. C-31). However, the judge refused to permit petitioner to include the expenditures for the project in petitioner's rate base during the amortization period (*id.* at C-32 to C-33).

The Commission modified the ALJ's decision by permitting petitioner to amortize its gross loss of approximately $13 million over a five-year amortization period (Pet. App. C-33 to C-34).[2] However, the Commission adopted that part of the ALJ's decision denying rate-base treatment for the unamortized portion of the loss (*id.* at C-32 to C-33). The Commission quoted at length from the decision of the ALJ on this issue (*id.* at C-32):

> There is no precedent, or reasonable justification in the record of this proceeding, to require ratepayers to pay a return on an expenditure that has not resulted in productive plant that is used or useful in the public service.

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[1]The Commission allows a utility to earn a return for funds used during construction. Thus, as petitioner notes (Pet. 7 n.5), petitioner's investors were compensated for the time value of their money until the project was cancelled.

[2]The Commission noted (Pet. App. C-34) that most of the parties were in agreement that a five-year amortization period was reasonable. It also observed that petitioner would not be able to achieve full recovery of its expenditures unless it were allowed to amortize its full $13 million loss rather than the $7 million net loss (*id.* at C-34 to C-35).

Ratepayers are not required to insure that a utility receive a return on all monies invested in the enterprise; ratepayers are required to pay a return on only those investments in properties that are used and useful in the public service.

3. The court of appeals affirmed the Commission insofar as is here relevant (Pet. App. A-1 to A-45). More specifically, the court upheld the Commission's refusal to permit petitioner to earn a return on its expenditures for the cancelled project (*id.* at A-7 to A-13). The court noted that in its prior decisions it had adopted a general rule that "expenditure for an item may be included in a public utility's rate base only when the item is 'used and useful' in providing service; that is, current rate payers should bear only legitimate costs of providing service to them" (*id.* at A-9). In light of this rule, and in reliance on this Court's conclusion that the "Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas" (*FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942)), the court of appeals held (Pet. App. A-9) that the Commission had not deprived petitioner of property without just compensation. In addition, the court rejected petitioner's contention that the Commission's decision to exclude cancelled project expenditures from the rate base was irrational and arbitrary (*id.* at A-9 to A-10). The court found that the Commission had "struck a reasonable balance between the interests of investors and ratepayers" (*id.* at A-10).

ARGUMENT

The decision of the court of appeals is fully in accord with settled principles, does not conflict with the decision of any other court, and does not warrant review.

In *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979), this Court observed that the Commission's ratemaking authority is not limited simply to deciding whether the

"cost[] is not imprudent." Rather, in fulfilling its broad statutory responsibility of ensuring that regulated utilities charge "just and reasonable" rates (15 U.S.C. 717c(a); 16 U.S.C. 824d(a)),[3] the Commission must balance the interests of consumers and investors. See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). As part of this ratemaking process, the Commission "may adopt any method of valuation for rate base purposes so long as the end result of the rate order 'cannot be said to be unjust and unreasonable' " to the consumer or the investor. *Washington Gas Light Co.* v. *Baker*, 188 F. 2d 11, 18 (D.C. Cir. 1950), cert. denied, 340 U.S. 952 (1951), quoting *FPC* v. *Hope Natural Gas Co., supra*, 320 U.S. at 602. See *FPC* v. *Natural Gas Pipeline Co., supra*, 315 U.S. at 586.

Moreover, in *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968), this Court explained that a rate that satisfies the statutory just and reasonable standard also meets constitutional requirements:

> [T]he just and reasonable standard of the Natural Gas Act "coincides" with the applicable constitutional standards, *FPC* v. *Natural Gas Pipeline Co., supra*, at 586, and any rate selected by the Commission from the broad zone of reasonableness permitted by the Act

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[3]Like Section 205(a) of the Federal Power Act, 16 U.S.C. 824d(a), which authorizes the Commission to regulate the transmission and sale of electric energy in interstate commerce by public utilities, Section 4(a) of the Natural Gas Act, 15 U.S.C. 717c(a), requires the Commission to set "just and reasonable" rates for the transportation and sale of natural gas. Because the relevant provisions of the Natural Gas Act and the Federal Power Act "are in all material respects substantially identical" (*FPC* v. *Sierra Pacific Power Co.*, 350 U.S. 348, 353 (1956)), this Court has cited interchangeably decisions interpreting the pertinent sections of the two statutes. See *Arkansas Louisiana Gas Co.* v. *Hall*, No. 78-1789 (July 2, 1981), slip op. 5 n.7.

> cannot properly be attacked as confiscatory. Accordingly, there can be no constitutional objection if the Commission, in its calculation of rates, takes fully into account the various interests which Congress has required it to reconcile. * * * [A]ny such rates, determined in conformity with the Natural Gas Act, and intended to "balanc[e] * * * the investor and the consumer interests," are constitutionally permissible. *FPC* v. *Hope Natural Gas Co., supra*, at 603.

These guidelines are clearly satisfied by application of the "used and useful" test for determining rate base. Indeed, this Court recognized long ago that, under the Constitution, a utility "is entitled to rates, not *per se* excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the services. * * * But it is not entitled to have included any property not *used and useful* for that purpose." *Denver Stock Yard Co.* v. *United States*, 304 U.S. 470, 475 (1938) (emphasis added). See *United Gas Co.* v. *Texas*, 303 U.S. 123, 144 (1938). See also *FPC* v. *Natural Gas Pipeline Co., supra*, 315 U.S. at 590; *St. Joseph Stock Yards Co.* v. *United States*, 298 U.S. 38, 56-57 (1936). As the court below observed (Pet. App. A-9), the "used and useful" test reflects the principle that "current rate payers should bear only legitimate costs of providing service to them." See *Tennessee Gas Pipeline Co.* v. *FERC*, 606 F. 2d 1094, 1109 (D.C. Cir. 1979), cert. denied, 447 U.S. 922 (1980); 1 Priest, *Principles of Public Utility Regulation* 174-177 (1969).

In this case, the Commission relied on the "used and useful" standard to balance the adverse interests of consumers and investors by allocating the actual expense of the Salem Harbor project to petitioner's ratepayers, while requiring petitioner's shareholders to bear the loss of any return on the unamortized portion of the expense during

the five-year amortization period. This result represents a "rational compromise" between consumer and investor interests. *Union Electric Co.* v. *FERC*, 668 F. 2d 389, 397-398 (8th Cir. 1981). The Commission's decision thus satisfied the statutory "just and reasonable" test, and, accordingly, "cannot properly be attacked as confiscatory." *Permian Basin Area Rate Cases, supra*, 390 U.S. at 770.

Nothing in the Constitution requires petitioner's ratepayers to bear the entire burden of petitioner's losses in the circumstances presented here. It is commonly understood that investment in public utilities is not risk-free. Accordingly, in establishing a utility's rate of return, the Commission seeks to ensure that the utility's investors are compensated for assuming the risks of doing business. See *FPC* v. *Hope Natural Gas Co., supra*, 320 U.S. at 603. But it is quite another matter to require consumers to indemnify investors against all risk of loss.[4] Thus, as this Court explained in *FPC* v. *Natural Gas Pipeline Co., supra*, 315 U.S. at 590 (citations omitted):

> [R]egulation does not insure that the business shall produce net revenues, nor does the Constitution require that the losses of the business in one year shall be restored from future earnings by the device of capitalizing the losses and adding them to the rate base on which a fair return and depreciation allowance is to be earned. * * * The deficiency may not be thus added to the rate base, for the obvious reason that the hazard that the property will not earn a profit remains on the company in the case of a regulated, as well as an unregulated, business.

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[4]One commentator has noted that if the practical difficulties of allocating risk between consumers and investors cannot be overcome, then one solution might be to require consumers to bear all risk of loss but pay to the investor only the lowest risk-free rate of return. Comment, *Allocation of the Risk of Constructing Electric Power Plants*, 1976 Wash. U.L.Q. 517, 526.

CONCLUSION

The petition for a writ of certiorari should be denied.

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